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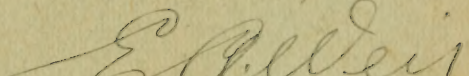

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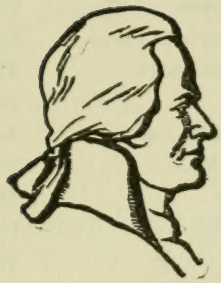

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Modern Business

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CORPORATION FINANCE

BY

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WITH THE COLLABORATION OF

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MODERN BUSINESS

VOLUME 11

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PREFACE

Thruout this treatment of corporation finance it has been the aim of the author to present the subject in a manner as clear, concise and non-technical as possible. Experience in teaching corporation finance to practical men in the Evening School of Accounts, Finance and Commerce of Duquesne University has governed the arrangement of the subject-matter. Promotion, for instance, cannot be intelligently discussed until the student first understands the tools and materials which the promoter has at hand. Nor is a detailed discussion of the various securities profitable, until the corporation itself and the general nature and sources of its capital are understood. Financial policy must be discussed after capitalization. In both arrangement and subject-matter, therefore, the Text differs materially from any heretofore published, but this will, it is hoped, add to its value.

The volume aims to be practical. Many of the illustrations given are within the personal knowledge of the writer. Much that has been heretofore written on corporation finance has been drawn entirely from current literature and records only the transaction of the larger corporations. As a matter of fact, very few men come into active touch with the management

of large companies, or the determination of their financial policies. While not neglecting large companies, a more thoro treatment than usual is therefore accorded in this Text to the financing of small and moderate sized corporations. Much new material is presented in an attempt to appreciate their peculiar problems and difficulties. Last resorts, and unusual methods of financing, some of them not approved, are discussed because of their practical importance to corporations in financial trouble.

The author desires to express most grateful appreciation to his father, F. J. Walker, of Erie, Pennsylvania, from whose broad experience in corporation work, devoted cooperation and expert criticism many illustrations and practical ideas have been drawn. The author is also indebted to Professor C. W. Gerstenberg, of the Institute staff, for many valuable suggestions.

WILLIAM H. WALKER.

Pittsburgh.

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CORPORATION FINANCE

CHAPTER 1

THE CORPORATION, A PRELIMINARY SKETCH

1. *Scope of corporation finance.*—Corporation finance, as distinguished from other branches of finance, relates to the methods and policies involved in securing capital and managing the finances of incorporated business enterprises. A simple example will serve to illustrate the scope of the subject.

When an individual desires to extend his business more rapidly than his earnings or means will permit, he can do so by borrowing or by taking in a moneyed partner, who will thereafter share with him the risk, management and profits of the business.

If these partners later desire to extend their activities beyond their own resources, they may do so by borrowing, or by admitting other new partners who will bring in additional capital, and who, like the original partners, will share the risk, management and income of the enterprise. But there are, generally speaking, rather definite limits to the expansion of partnerships thru the admission of new members. Each partner participates in the management and assumes full secondary liability for the debts of the con-

cern beyond his own share, thereby guaranteeing creditors against the incompetence or dishonesty of his associates. Furthermore, the life of a partnership is limited by the life of each individual partner and by the terms of the partnership agreement. New partners cannot be admitted or old ones dropped without unanimous consent. Under such conditions men will not freely invest capital. Obviously, if the business under discussion expands further, some form of organization other than the partnership will be required to interest new capital.

The next expansion will call for incorporating the enterprise under a charter from the state. Here for the first time corporation finance enters this business. The new association is a corporation and the right to participate in the control, risk, income and assets of the business is called capital stock. The members are stockholders, with rights in the company proportioned to their respective holdings. To obtain capital for the company by the sale of stock or by borrowing, involves corporation finance. The management of the business is now delegated by the stockholders to a board of directors and, with the proper legal sanction, the capital of the enterprise may be indefinitely expanded by the sale of new shares whenever funds are needed and investors can be found to buy them.

In changing the form of the business from individual ownership to partnership, and from partnership to corporation, no vital changes are necessary in the methods of buying, producing, selling, shipping,

billing or collecting from customers. The form of association does not necessarily alter the manner of conducting the current operations involved in production and distribution, and corporation finance does not deal with them, except incidentally.

But it should be noted that the methods of raising additional capital are entirely changed in converting the enterprise from a partnership to a corporation. Partners are associated personally on a basis of mutual confidence; stockholders may be entire strangers, not acquainted with the business, and it takes great skill to interest them to the extent of investing capital in it.

To finance an enterprise means to provide the capital necessary to begin and maintain its operations. Corporation finance, therefore, relates only to the assembling of capital thru the sale of corporate securities—stocks, bonds and notes—and to matters of financial policy affecting the distribution of control, risk and income among the holders of such securities.

2. *Nature of a corporation.*—One hundred years ago, Chief Justice Marshall of the United States Supreme Court, defined a corporation as "an artificial being, invisible, intangible, and existing only in contemplation of law." This definition conveys the essential fact that a corporation is not a natural person, but a separate legal entity, to which the law assigns a perpetual or continuous existence, independent of the lives of the persons composing it. The stockholders, in their collective capacity, compose the

corporation, but it is governed by duly appointed directors and officers. The company, as an artificial person, cannot exist or act, except thru human agency. Like natural persons, it must be held responsible for wrongful acts and omissions. The law therefore holds its officers, directors and stockholders responsible for the misdeeds of the corporation and visits upon them appropriate punishment for corporate offenses.

The charter is the birth certificate of the corporation; and the corporation ceases to exist whenever the charter is annulled or abandoned. Since the corporation is not a natural person, it has no natural rights and privileges but only such as are specifically extended to it by law and charter, or which may be reasonably implied from the expressed powers. The charter is a grant from a sovereign legislature, obtained by special enactment or by appropriate procedure under general laws.

Altho the corporation is an old institution, its extensive use is modern, over nine-tenths of the corporate activities of the United States having been initiated since the Civil War and fully half of them in the past fifteen or eighteen years. Obviously, it must possess great administrative and financial advantages to receive such general adoption.

Within the memory of our older citizens, means of communication and transportation were crude and expensive, and nearly all enterprise was local in character. The investment of capital, production and distribution of goods, and the extension of credit were

local and personal affairs, man to man, friend to friend. Competition, accordingly, was local and not over severe, and margins of profit were higher than now.

With the vast development of railroads, telegraph lines, telephone and steamship lines following the Civil War, conditions were changed. Following the lead of the great railways and a few great industrial concerns, larger business units were formed to conduct interstate trade and to outsell the smaller local concerns. This was the result of cheap communication and transportation, together with the possibility of financing and managing large aggregations of capital thru the corporate form. Economies of large scale production and distribution, with the resulting interstate competition, soon reduced profits to a point which drove many of the smaller concerns out of business or forced them in time to combine or enlarge under the corporate form.

The passing of the small localized business marked the death of the partnership as the principal form of association and ushered in the age of the corporation. Business now demands the large capital that may be secured only by a wide distribution of ownership, together with expert centralized management, and these the corporation affords. The development of corporations has been so rapid in recent times that the science of corporate finance and management is always several years in advance of the law and the courts.

3. *Formation of corporations.*—To form a corporation, stock subscriptions are first taken on lists provided for that purpose, after which a few of the subscribers, acting as incorporators, draw up a request that the state grant a charter to the proposed corporation. This is known as an "application for charter," or a "certificate of incorporation," and must show the name of the proposed corporation, the location of its principal office, the nature of its business, and other essential facts regarding it, followed by the signatures and addresses of the incorporators. Usually, a list of stockholders and the number of shares subscribed by each is included. When this certificate has been filed for examination in accordance with law, and the application granted by the proper state authority, it becomes the charter of the corporation. Each state, thru general corporation laws, prescribes in detail the procedure in forming corporations, extent of their powers, and the rights of stockholders, directors and creditors. Upon receiving the charter, the stockholders meet for the purpose of adopting by-laws, electing directors, and otherwise perfecting the internal organization of the company, which is then ready to do business. Unpaid subscriptions are called by directors as rapidly as funds are needed, or as provided in the subscription lists.

The real difficulty arises in securing adequate capital and this is the work of the promoter, or financier. If corporations could do business without capital, all of us would be great corporation executives—for a

time. Any good lawyer can take care of these formal details of incorporation and organization, but to depend upon him further for business and financial advice is no more sensible than taking a broken leg to the dentist.

4. *The lawyer in corporation finance.*—Candor compels the statement, based upon the grievous experience and careful observations of business men, that lawyers give notably unsound financial advice. Corporation law is a far different thing from corporation finance. There are, of course, some well informed financial lawyers, found mainly in the very large cities, but ninety-nine lawyers in a hundred have given no time to the study of finance, and matters of financial expediency are outside their realm.

If this appears hard on the profession, it is nevertheless true and is a self-inflicted fault. The writer can cite many cases of business failure due to the financial advice of lawyers, and yet the victims would never have thought for a moment of reversing the process and seeking legal advice from a financial expert. The fault lies as much with the business man who seeks such advice in the wrong place as with the lawyer who thinks he has learned finance by studying law. Of course, our reader, if he be a lawyer, will understand that he is the one out of a hundred, above referred to, who gives sound financial advice.

5. *Powers of the corporation.*—The corporation receives limited powers from the constitution and laws of the state and from its charter, including

the power to engage in a specified line of business, to contract, sue and be sued, borrow, and own certain kinds of property. Unlike an individual, who has general power to do anything not prohibited by law and custom, the corporation is restricted to powers specifically granted or reasonably implied.

A corporation does not extend, except by courtesy, beyond the jurisdiction of the state which chartered it. A New York corporation, for instance, cannot own property or conduct a branch in Pennsylvania, unless the latter state chooses to extend these privileges. Outside the state of its creation, it is called a foreign corporation. Foreign corporations, by the comity existing between states, are recognized in every state of the Union; in fact, are welcomed because of the business which they bring into the state and the taxes which they pay there.

If corporations exceed their powers, they may be punished by forfeiture of charter, fines, forfeiture of right to sue and recover, or other appropriate penalty. The corporation must abide by the laws both of the state which chartered it and the one in which it does business as a foreign corporation.

6. *Capital stock.*—The stockholders of a corporation are its owners, subject, of course, to the claims of creditors for advances to the company. A share of stock is one of many equal parts of, or divisions of interest in, the corporation, and the interests of various stockholders are in proportion to the number of shares owned. Stock certificates are issued as evi-

dence of the ownership of the stock itself. The earnings of the corporation available for distribution are paid to the stockholders in the form of dividends upon the stock. These may be at the rate of so many dollars a share or a percentage of par value; thus, if the par value of a share is one hundred dollars, the dividend may be either five per cent on par or five dollars a share.

Par value is the price which the original subscriber is supposed to have paid, in cash or property, for the share. It has no necessary relation, as we shall see later, to the actual value of the share or the actual amount paid for it. It is usual for all shares of the same issue to possess the same par value. The par value of the stock of the corporation is limited by the state at the time of charter and is called the authorized capitalization. The authorized capitalization may be increased from time to time with permission from the state, so that new securities may be sold to obtain additional capital.

Capital stock may be of different classes, so that some holders are preferred over others in the extent of risk assumed, control granted, or priority of dividends. Stock with any such preference is called preferred stock, and all other issues are called common stock. It is customary to limit the return upon preferred stock to a certain rate, usually six or seven per cent, in exchange for the preference which it enjoys in the distribution of assets, earnings and voting powers.

7. *Management of the corporation.*—Altho the stockholders are the owners of the corporation, they are not its managers, this being one of the essential differences between a partnership and a corporation. Management of the corporation is vested in a board of directors, and in certain officers chosen by the board or the stockholders. The officers and directors are limited in the exercise of their duties by the provisions of by-laws which the stockholders have enacted. The individual stockholder, acting alone, has no power whatever in the management. Acting together, however, stockholders may, in meetings duly assembled and formally conducted, direct or control the management in important matters of policy, such as the material enlargement of the business, issue of new securities, mortgaging of assets, sale of capital assets, merger, dissolution, receivership, etc. Outside such formal meetings, in which each stockholder may vote directly or by proxy in proportion to his interest, the stockholders have no power in management. Even in meeting assembled, their power is limited to the election of directors and to voting upon certain important policies which vitally affect their interests.

8. ***Right of stockholders to dividends.***—Dividends represent the division of corporate earnings among stockholders. They are the only means, aside from fraud or manipulation, by which the earnings of the company may reach its owners. We shall see later

that the dividend policy of a corporation is an important element in its financial management.

Stockholders have no rights to dividends until they have been declared by the directors, and directors have no right to declare dividends unless they have been actually earned. To pay dividends otherwise than out of net earnings impairs the capital of the company, and is unlawful unless the stockholders vote to reduce the capital or dissolve the company. Stockholders have a right to know, and directors are under obligation to insist, that the paid-in capital of the company be kept intact so as not to impair the stockholders' investment.

Even tho dividends have been earned, the stockholders cannot compel the directors to declare or pay them unless they can prove to a court that there has been fraud, oppression or gross mismanagement in the affairs of the company, by reason of which dividends are being improperly withheld. The courts are loath to interfere in the management of corporations and will not extend relief to stockholders unless it is clear that every other remedy has been exhausted. This rule often seems harsh, but it is for the best interests of all concerned.

9. *Right of stockholders to information.*—Theoretically, stockholders have the right to examine the affairs of their company and for this purpose to employ counsel to assist in the examination of the general books. This right is supposed to exist where

a stockholder has good reason to suspect fraud, oppression or flagrant mismanagement, and is supposed to be respected by the corporation when the exercise of the right will not interfere materially with the running of the business, nor open the affairs of the company to the scrutiny of competitors.

As a matter of fact, however, the right of inspection does not exist in practice. It is clearly impossible for large corporations to open their books to the inspection of stockholders. To do so would involve unnecessary inconvenience and place their affairs as an open book before competitors, who could easily gain access by the purchase of a few shares of stock. Companies uniformly refuse requests of this kind, and the courts protect them by demanding very clear circumstantial evidence of fraud, oppression or mismanagement before ordering such a disclosure of corporate affairs.

As a matter of policy, most companies submit periodic reports to the stockholders, containing more or less satisfactory information. It is proper to add that the management seldom accuses itself of anything but hard work and good results in such reports.

10. *Negotiability of shares.*—A partnership is founded upon mutual consent and confidence. Interests in a partnership are therefore not transferable, except by unanimous consent. Stockholders of corporations, however, do not have or require a choice of associates, since they are liable for corporate debts only to the extent of their investment and have indi-

vidually no voice in management. Stock may therefore be sold and transferred, or pledged to secure debt, or proxies given for voting it at the will of the stockholder. Such transfers are facilitated by the fact that the stockholder's liability is limited to his investment.

Since the ownership of stock is evidenced by registration in the name of the owner upon the books of the company, and by the issue of certificates, a transfer must usually be recorded upon the books before the new owner has any right to vote or to receive dividends. The registered owner possesses these rights, and any adjustment of dividends upon the sale of stock is ordinarily made by adding accrued dividends, at the established rate, to the selling price of the stock.

In practice, shares are delivered by merely handing over the certificate, with the power of attorney upon the back signed in blank by the former owner, authorizing the holder to register the shares upon the books of the company in the name of the new owner. This new owner's name need not be designated until the certificate is actually surrendered and a new certificate taken out. The burden rests upon the purchaser to record his shares properly upon the books of the company. By means of this power of attorney signed in blank certificates may be bought and sold without a formal written assignment each time, and pass freely on delivery, thus facilitating transactions and minimizing expense. Stock certificates technically are not negotiable instruments in the sense that commer-

cial paper is negotiable, since mere delivery of the certificate, with power of attorney properly signed, does not complete the delivery of the stock. The transfer must be recorded on the company books before it is complete, in order that the company may know who is entitled to vote and receive dividends on its stock. Nevertheless, stock is readily negotiable, that is, it may be easily transferred from one owner to another. Negotiability must not be confused with marketability, as stock which is readily negotiable is often not salable at any price.

The ease of issuing and transferring corporate shares in small amounts makes them a favorite form of investment and enables corporations to draw funds from many thousands of small and scattered investors. Large organized markets for trading in shares have naturally grown up to supply the demands of investors, the chief of these being the London and New York Stock Exchanges, Paris Bourse, and other exchanges of similar type. Thousands of banking and brokerage houses are engaged in the business of buying and selling stocks and bonds, a business which depends entirely for existence upon the great utility, convenience and popularity of corporate stock as a form of investment.

11. *Powers of directors and officers.*—It must not be supposed that officers and directors are unrestricted in their powers of management. Legally speaking, they are the agents of the stockholders in the management, but not subject to detailed interference on the part of stockholders. Directors are

usually elected annually by the stockholders, who may thus exert control by removing incompetent or distasteful directors from office.

The directors in turn usually choose the officers, who hold office during the pleasure of the directors. Both directors and officers are subject to the provisions of the by-laws, and, in certain leading matters, to the direction of stockholders, upon formal resolution in meeting assembled. The by-laws govern the internal organization and distribution of authority. They are usually subject to change by the stockholders upon some majority vote, such as two thirds of all shares outstanding, or some other proportion.

The directors have individually no powers of management, but possess full access to the affairs of the company. To be binding, all acts of directors require formal resolution in meeting duly assembled, unless the board has in this manner previously delegated authority in certain matters to individual directors. In this manner, by resolution properly recorded, the directors may, but seldom do, regulate the actions of officers to the minutest detail. Directors meet periodically, and also hold special meetings to transact important business and determine matters of policy, leaving the officers in charge of all details.

The officers, as paid servants of the company, are not responsible for losses arising from ordinary business mistakes, so long as they exhibit integrity, good faith and reasonable care in the affairs of the company. The directors, who are usually not paid for

their services, are bound only to exert ordinary diligence and prudence in directing the company.

Both officers and directors, however, may become individually responsible to stockholders or creditors for fraud, gross negligence, or exceeding their authority. Officers are usually directors, and their knowledge of the affairs of the corporation frequently enables them to dominate the board. From the financial viewpoint, this fact is important, and the reader is asked to note carefully that the control of corporations is customarily pyramided into the hands of the directors and officers, the board of directors controlling the policy of the company, and the administrative officers dominating the board.

12. *Advantages of the corporation.*—From what has been said, the business and financial advantages of the corporation must be apparent. The principal ones may be summarized as:

(a) Perpetual existence, without regard to the lives of stockholders. If a stockholder dies, his interest merely passes to his descendants, and the corporation continues without interruption.

(b) Limited liability of stockholders, making it unnecessary for them to choose their associates or to participate directly in the management.

(c) Transferability of interest, creating a broad market for corporate shares.

(d) Divisibility of interest, making it possible for stockholders to have large or small interests in the corporation, divided according to their means or de-

sires, including wide distribution of shares among absentee owners, and making possible large aggregations of capital under centralized management.

(e) Delegated and centralized management by directors and officers, representing stockholders in the aggregate, relieving individual owners from the cares of administration and the risks of partnership association.

Other advantages of the corporate form might be mentioned, but the above will suffice here.

13. *Disadvantages of the corporation.*—Certain disadvantages of the corporate form, most of them of small importance, may also be mentioned:

(a) Lower credit, due to the limited liability of stockholders. California affords an interesting exception, for in that state, stockholders are liable to creditors beyond their investment in the capital stock.

(b) Limited powers. Corporations possess only the powers granted to them by law, while individuals and partnerships possess all except those prohibited by law.

(c) Unusual expenses, such as charter fees, various special forms of taxes upon domestic and foreign corporations, taxation of corporate stocks and bonds, etc. The partnership and trusteeship escape some of these forms of taxation.

(d) Government regulation. The Federal and state governments closely regulate the activities of corporations, and require frequent reports of their condition and business. This regulation is best typi-

fied by the control of the Interstate Commerce Commission over railroads, and of the Federal Trade Commission over industrial companies.

14. *Is there a substitute for the corporation?*—The increasing taxation and regulation of corporations by the Federal and state governments, imposing in some instances burdens that are almost prohibitive, have stimulated renewed interest in an old and recognized form, the business trust, under which certain parties, known as trustees, are vested with the legal title and management of property for the benefit of others, described by the law as beneficiaries or cestuis que trustent. Certain flexibility of interest is obtained by issuing negotiable certificates of beneficial interest, divided into equal units, somewhat similar in effect to certificates of capital stock. These certificates refer to the trust agreement under which the trustees are acting and set out the principal rights of holders and the extent of their interest in the enterprise.

This form of association has reached its greatest development in Massachusetts, and is variously designated as the Massachusetts Trust, Expressed Trust, Business Trust, etc. Its weakness lies in the fact that certificate holders cannot control the trustees to the extent that stockholders control their directors. The trustees, once elected, are not agents of the certificate holders, but act independently as legal owners of the property. The courts recognize the business trust as an attempt to dodge the liabilities of the corporate

form, and whenever the trust agreement subjects the trustee to any considerable control by beneficiaries, the courts are likely to construe it as a partnership agreement, with the certificate holders as partners and the so called "trustees" as their agents. These decisions have tended to limit the use of the trust as an instrument of business and make it doubtful whether the business trust will ever supersede the corporation on any large scale. Of course, it lies within the power of the state to declare such business trusts illegal, or to subject them to the same taxation and control as corporations. It would be very difficult, however, to prohibit or restrict them by law without hampering the use of the trust form for other necessary and desirable purposes.

15. *Corporate combinations.*—One company may control the stock of another, and if both are engaged in the same or allied lines of business, the latter is termed a subsidiary company. If the subsidiary company grew naturally out of the extension of the business the original corporation is called a parent company. A company which is formed for the purpose of acquiring and holding the stocks of other companies, for reasons other than pure investment, is known as a holding company. An operating company is one which itself engages in production or distribution. Many corporations are both operating and holding companies.

The principal forms of corporate combination may be summarized as follows:

(a) The holding company.

(b) The voting trust. This is a device to concentrate diverse interests in the same corporation, or to harmonize the management of several corporations, by placing a controlling interest in the capital stock in the hands of trustees, who thus acquire voting control and eliminate competition under a continuous and uniform policy of management.

(c) The leasing by one corporation of the properties or assets of other companies. This concentrates the management largely into the hands of the lessee company.

(d) The information of selling companies, which, by controlling the market and apportioning the business, are able to prevent competition and dictate the policies of the various producing companies concerned.

(e) The formation of trade associations, which, thru gentleman's agreement, regulate trade practices, prices, etc. Legally speaking these are not combinations, as they exist, ostensibly, only for the purpose of advancing the industry thru the exchange of information. As a matter of fact, by gentleman's agreement or tacit understanding, trade competition is often closely or nearly eliminated by these voluntary associations.

In addition to the above forms, in which corporations may combine without losing their corporate identity, there may be mentioned the following methods of combination in which the corporate identity is lost:

(a) Physical Merger, in which one company purchases the assets of other companies, which then wind up their affairs or lie dormant.

(b) Dissolution of competing companies and the placing of their assets in the hands of trustees, whose certificates of beneficial interest are issued to former security holders in exchange for their stocks and bonds.

It should be noted, however, that a corporation cannot become a partner in any enterprise, as that would partly subject its assets to the control of other partners outside the company, who have not been elected by stockholders. This would be a departure from the principle of agency, under which the directors, and directors only, manage the corporate property and affairs in the interests of stockholders.

REVIEW

Define corporation finance.

What are the general powers of a corporation, and what are the usual limitations upon these powers?

Distinguish between the ownership and the management of corporations.

Discuss the rights of stockholders.

State the duties and powers of directors.

What are the advantages and the disadvantages of corporations?

In what sense is a trust a substitute for a corporation?

CHAPTER II

CAPITAL OF THE CORPORATION

1. *Care in the use of terms.*—In considering corporation finance it is necessary at the outset, to learn its language and to distinguish carefully certain terms relating to capital and capitalization, particularly the following:

Capital
- Capital Funds
- Capital Investment
- Capital Assets

Capitalization
- Capital Stock
- Authorized Capital
- Outstanding Capital

The first four of these expressions refer to capital, the last four to capitalization.

The capital of a corporation consists of its assets. Land, buildings, machinery, stock, cash, patents and all other forms of property owned by the company constitute its capital. Throwing aside fine economic distinctions, we may state that, for practical purposes, the value of assets is determined either by their earning power or by the price which they will bring in

the market. The market price in turn is itself determined mainly by earning power, since investors purchase securities for the dividends which they will bring, after making due allowance for depreciation, risk, etc. Productive efficiency, or earning ability, is therefore the prime test of the value of assets. In fact, the actual capital is seldom accurately known, altho it may be closely approximated by modern accounting methods.

2. *Capital investment.*—Taken literally, the words capital investment apparently refer to the actual original cost of the assets of the company, the total amount invested in the business from every source. Since the assets fluctuate constantly in value, they are likely to be worth at any given time more or less than their original cost, and accordingly the capital investment and the capital have no fixed relation, except at the time the investment is originally made. If a new company gets its money's worth, its capital in the beginning should equal the capital investment.

A less accurate, but more commonly used, definition refers to capital investment as the total amount received from the sale of the corporate securities. This definition eliminates the investment of new capital out of the profits of the business itself, on the theory that profits do not belong to the stockholders until they have been declared in the form of dividends, and that the investment consists only of contributions which security holders have made from outside sources. It is, of course, apparent that an increase

of capital out of earnings changes neither the capitalization nor the investment. On the other hand, the payment of unearned dividends reduces both assets and investment without affecting the extent of capitalization.

In this Text, we shall use the more popular definition, and refer to capital investment as the actual amount received by the company from the sale of its securities. Funds thus secured are known as *capital funds,* because they are invested permanently in the business and have been secured by increasing the outstanding capitalization.

3. *Capital and current assets.*—The capital of a concern consists partly of assets which are fixed or are essential to the business, known as *capital assets,* and partly in assets of a current nature, employed from day to day in conducting the business, but no particular part of which is essential to its continuance. These latter are known as *current assets.* Some companies, such as steel mills, have a greater percentage of capital assets, whereas others, such as wholesale groceries, have a greater percentage of current assets. Both together equal the capital of the concern.

Land, buildings, machinery and other similar items not regularly bought and sold by the company are capital assets. Raw and finished stock, cash, accounts receivable, etc., are current assets. Current assets are not a part of the plant.

4. *Capitalization.*—The word "capitalization" is one of the most misused expressions in corporation

finance. In addition to capital stock, corporations issue other securities known as notes and bonds. Capital secured from the sale of stock is called owned capital, whereas capital secured from the sale of notes and bonds is called loaned or borrowed capital. The ownership, control, management and risk of the enterprise is divided in various proportions among these securities. The term "capitalization" refers to the amount and character of the securities and should be distinguished carefully from the keyword "capital," which relates to the *assets* of the company and not to its *securities.*

Capitalization is of two kinds—quantitative and qualitative:

Quantitative. The capitalization is the total par value of the outstanding stock, bonds and long term notes of the company. Trade credit, bank loans, and other current indebtedness are not included.

Qualitative. Capitalization is the plan of distribution of the control, risk and income of the business among the various security holders. This definition relates to the kind of securities, and not to the amount; whereas the first definition relates to the amount of securities, and not to the kind. To avoid confusion, we shall refer to this qualitative definition as the plan of capitalization.

5. *Authorized and outstanding capital.*—Legal theory does not always harmonize with financial fact. Out of this discrepancy grow many terms in common usage that are not justified by accurate definition.

The term "authorized capital" is one of these. By this term is really meant "authorized capitalization." The state, in chartering a company, limits the number of shares and the par value of the shares which the company may issue, and this limit is known as "authorized capital." The state fixes no limit on the value of the company's assets, but merely on the par value of the stock, and it is therefore capitalization and not capital that is authorized.

The outstanding capitalization of the company consists of the total par value of securities that have been subscribed and paid for, regardless of their real value, or the amount authorized to be issued. The authorized capitalization does not include bonds. Every company has the inherent right to borrow for the purpose of conducting its business without authority in the charter, and bonds are issued under this general borrowing power.

Thus, we say that the United States Steel Company has an authorized capitalization of $550,000,000 common and $550,000,000 preferred stock. But its actual outstanding capitalization includes also $304,000,000 in bonds.

6. *Kinds of corporate capital.*—The corporate capital, somewhat in the order of its bonding value, may be classified as follows:

1. Land
2. Buildings
3. Equipment
4. Securities owned and necessary to the business

5. Securities and other unattached or outlying properties not necessary to the business
6. Raw material and supplies
7. Work in process
8. Finished product
9. Bills and accounts receivable
10. Cash
11. Good will, including secret processes, patents, copyrights and trade names.

While all forms of corporate assets are supposed to be productive, as otherwise the corporation would not have acquired them, they nevertheless represent different degrees of productiveness and risk. Many forms of assets cannot be converted readily into cash, except at great sacrifice. Second hand machinery, for instance, is often difficult to sell, altho, it may be of great value to a running business. Capital tied up in unproductive assets or in forms not easily convertible into cash is naturally not good security for loans. Such assets, therefore, must be provided by the sale of capital stock, which absorbs the risk of corporate ventures, while bondholders provide funds to purchase the more staple and productive assets. This fact lies at the basis of every scheme of capitalization and renders necessary the close analysis of each enterprise before attempting to finance it.

7. *Compensating the owner of capital.*—We have already defined capitalization as the method of distributing control, risk and income among security

holders. Those who contribute capital to a corporation must be paid for its use. Corporations are formed to conduct business for profit, and these profits appear in the form of dividends upon stock or interest upon bonds and notes. But the element of risk is ever present in corporate enterprise, and for assuming it the security owner demands more than mere interest for the use of his capital. This additional charge may be designated as "premium for the assumption of risk."

On the other hand, there are special advantages to be had from participating in the management or control of certain corporations, aside from the dividends or interest received. Directors of banks and insurance companies, or of large industrial and railway corporations, for instance, feel that the prestige of their position is worth something apart from the direct earnings upon their investments. How, then, shall the owners of this capital be compensated for its use?

The answer involves the entire plan of capitalization. There are four elements to consider:

1. Control
2. Management
3. Risk
4. Income.

These elements must be so arranged in the scheme of capitalization as to compensate the investor for:

1. Use of his capital
2. Risk of losing it.

Let us examine what value each of these factors possesses for the various classes of investors.

8. *How control is acquired.*—By control we mean the power to direct the policy of the company. Control is exercised thru the voting power of security owners, and to some extent, in the case of bonds, thru the power to foreclose in the event of default. Obviously, the chief advantage of control lies in the ability to prevent loss thru the mismanagement or manipulation of others. Actual control requires a majority voting power, altho, as we shall see, this does not necessarily require the ownership of a majority of the outstanding stock. Voting power may be extended to certain classes of securities and withheld from others, or it may be contingent upon a certain event. Preferred stock, for instance, may be given a vote if dividends are not paid, but not permitted a vote when dividends are paid regularly. It often happens that even a minority of the voting stock may control, as when the shares are divided among a great many small holders, many of whom do not exercise the voting privilege. This leaves the few larger interests in control; altho having merely enough votes to carry a poorly attended election. Control may also be secured thru the voting trust, in which stockholders transfer their voting privileges to trustees, or by gathering proxies from other stockholders.

9. *Relation of controlling and minority interests.*—A voice in the control is an important consideration to security-holders who desire to lessen, or in some extent to govern, the risks of their investment. Sometimes, however, control is bought purely for the purpose of manipulating corporate affairs, or gaining prestige or some other outside advantage. Such a control is always dangerous for the corporation and the minority interests, because it gives opportunity of personal profit at the expense of the company. This has been frequently demonstrated in the railroad field, where certain large stockholders of railroad companies, having become directors thru their voting power, have used their positions to secure exorbitant salaries or preferential contracts for other concerns in which they are interested, sometimes in the underwriting of securities, sometimes in the purchase of equipment. Excessive personal profits have thus been made at the expense of the railroad which they were supposed to represent. The practice became so general that a clause was inserted in the Clayton Act to stop it by subjecting such contracts to open competition, under the supervision of the Interstate Commerce Commission.

Sometimes the controlling interests, while seeking no individual advantage, endeavor to secure preferences for their own classes of securities at the expense of other securities. This illustrates the importance of the other security-holders having a voice in the management, so that they may upset any such preferences

and insure themselves a square deal. Ordinarily, extending a voice in the control to a certain class of security is merely intended to lessen the risk of that security, or to offset the natural risk which surrounds it. Common stockholders usually control the corporation, because they are given preferences in lien or income over bondholders and preferred stockholders. The further application of the principle of control will be left until later chapters. It is sufficient here to point out that control is a factor of great importance in the financial plan.

10. *Element of risk.*—Every business and every security possesses an element of risk. Indeed, one cannot own wealth without assuming the risk of losing it in one way or another. One has only to scan the price fluctuations of the best bonds and stocks, and the record of mortgage foreclosures to be convinced of this fact.

In the field of business thousands of failures occur annually, ranging from that of the large corporation with many millions of dollars invested, to that of small companies, partnerships and individual enterprises. The statement has often been made, and is probably true, that nine out of every ten corporations within ten years from the date of formation are either dissolved, failed, reorganized or swallowed up by other companies. Very few companies survive a period of twenty-five years without financial difficulty. As a class, railroad securities have been, with the exception of government and municipal bonds, the most substan-

tial issues in the United States, and yet over half the railroad mileage of the country has been under receivership and reorganization within the past fifteen years. No wonder the owner of common stock lies awake nights.

A substantial percentage of all new corporations practically fail before they get under way, owing to faulty or fraudulent promotion. In many cases, the promoter very generously pockets the entire capital in exchange for a patent which he has purchased for little or nothing. One promoter was heard to remark that the investor always got his money's worth, but that he usually got it in experience. This is undoubtedly true, and it is also true that experience is the most costly school in the world. It is a very important financial fact, too, that very few people are smart enough to learn from the experience of others. If this were not true, there would be neither so many worthless promotions nor such a large number of "lambs" constantly led to the slaughter. Fatherly advice has never played a large part in corporation finance. The average man dies just about the time his experience has become valuable. The new generation then begins all over again, without analyzing the experience of their predecessors or profiting much from it.

11. *Payment for risk-taking.*—Such are the risks of business, and for assuming this risk, the investor must be paid. Therefore, loaned capital demands not only an interest rate for its use, but also an added

rate to compensate for the risk assumed. The rate paid for the use of the capital may be called the true interest rate. It averages perhaps between 3.5 and 4 per cent in this country. The balance of the interest paid upon bonds, and of dividends paid upon preferred stock above the true interest rate, represents the compensation to the owners of those securities for assuming the risk of investing in them. The only reason why some securities sell below the true interest rate is that they are limited in amount and are prescribed by law for certain purposes, such as the investment of trust funds, the circulating privilege upon two per cent government bonds, etc. The fact that bondholders and other holders of preferred securities receive anything for the risk of their investment shows how hazardous must be the common stock, which assumes the marginal risk.

12. *Management and income.*—Management must be differentiated from control. Certain stockholders owning a majority interest may control a corporation, and yet not manage it. The management is usually vested in a certain few chosen officials who are satisfactory to the controlling interests, but who themselves may not possess the actual control of the business. The manager has a double inducement for investing in the company. First, it secures him an income as manager, and secondly, it enables him to watch his investment and guard it intelligently. Since, however, only a very limited number may be managers, the influence of this factor upon the plan

of securing capital is very slight in the aggregate. Usually control, risk and income are mentioned as the factors which determine the financial plan, and management is omitted entirely.

Income is the chief purpose of investment and is received in the form of dividends or interest. These will be treated at length in succeeding chapters.

13. *Capital for new enterprises.*—In deciding how capital shall be obtained for a corporate enterprise one must consider not only the various forms of capital and the various persons from whom it may be secured, but also the stage to which the enterprise has developed. The latter will to a considerable extent determine the means by which money can be obtained, as well as the persons to whom an appeal can profitably be made.

When an enterprise is wholly new and is not formed to take over some existing concern, capital is obtained usually in the form of cash and by the issue of common stock. The enterprise being new and its earning capacity untested, it involves a large element of risk, which all who participate must be willing to share. In such cases the capital stock is usually subscribed in small amounts by a relatively large number of persons. Particularly is this true of industrial corporations.

The conditions under which preferred stock can be issued do not obtain in such case. On the one hand, investors have no guarantee that the dividends on the preferred stock will be paid. On the other hand, the

subscribers to the common stock cannot afford to promise a definite return to the holders of other stock while the success of the undertaking is still problematical.

14. *Incorporating existing enterprises.*—As a matter of fact, few corporations outside of the banking business and a few other limited fields start as absolutely new ventures. More commonly the corporation is formed to take over an existing business. When this is done the past record of the concern which is absorbed in the new corporation often gives a basis for issuing preferred stock.

Under these conditions the two forms of stock are frequently employed, and in this case cash subscriptions are apt to be only a part of the total contribution to the capital stock, the remainder consisting of the assets of the concern which is being taken over by the new corporation. In the case of holding companies, the new bonds or stocks are given in exchange for the securities of the constituent companies.

15. *Extending the capital of an existing corporation.*—The most interesting problems of corporation finance arise when a corporation is already in existence and desires to extend its operations. Numerous sources of capital are open, and there are various ways of obtaining it. As a going concern, newly incorporated, the company can probably retain the capital which was employed in the business when it was a partnership or individual proprietorship, and in addition draw new capital by virtue of its corporate form.

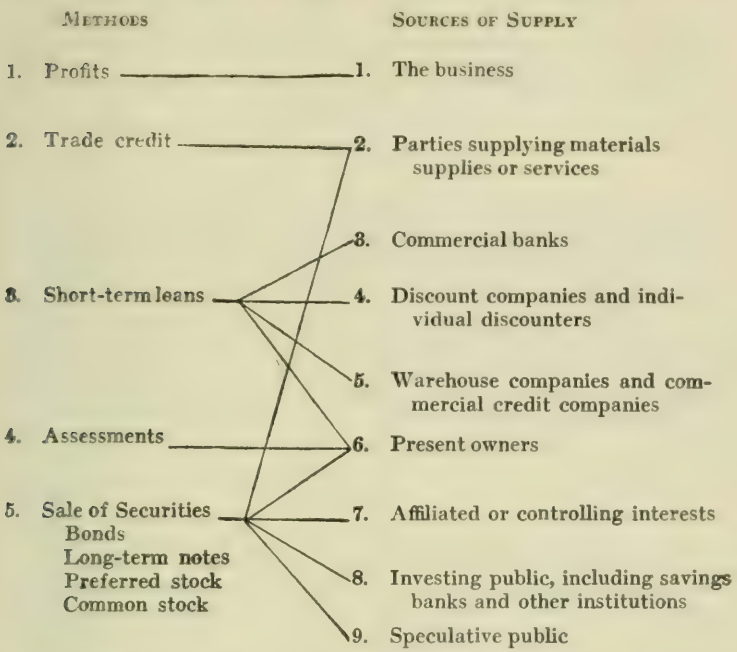
A clear idea of how capital is raised by an existing corporation, and of who furnishes it, may be had from the diagram on page 37.

In the left-hand column are noted the various means of securing capital; in the right-hand column are given the principal persons or classes of persons who furnish it. The connecting lines show the usual sources from which capital can be obtained by each method. This chart takes no account of the brokers, bondhouses, underwriters, stock exchanges, or other elements in the purely distributive machinery utilized to get the various securities into the hands of their ultimate owners.

Of the five methods here named, the first four, it will be plainly recognized, are not peculiar to the corporation, and might be equally applicable to a partnership. The fifth group, the issue of securities, is a very broad one. To avoid confusing the chart the sale of bonds and long-term notes, of preferred stock, and of common stock are grouped together, altho they constitute three separate and distinct methods. They will be considered in later chapters.

If attention is directed to the right-hand column, it will be noted again that the sources of capital supply numbered from 1 to 6 are, in the main, open to partnerships as well as to corporations. The single qualification of this general statement is found in the fact that concerns with which the corporation has dealings may, thru the purchase of securities, contribute to the capital of the company, but are rarely willing or able to join in a partnership enterprise.

METHODS OF RAISING CAPITAL AND SOURCES OF SUPPLY



16. *Fixed and working capital.*—It will be noted, further, that in the main the corporation can acquire working or fluid capital by the same means and from the same sources as the partnership. It differs from the partnership in its acquisition of fixed or permanent capital. While the partnership can draw for such purposes only on the resources of the partners, the corporation can enlist the capital of any one who will purchase its securities.

The foregoing summary of how capital is obtained by the corporation is merely intended as a sketch.

The detailed consideration of the different methods of raising corporate capital and the circumstances under which each applies will form the subject-matter of succeeding chapters.

REVIEW

What is the distinction between capital and capitalization?

Distinguish between authorized and outstanding capitalization.

Of what does corporate capital consist?

Under what circumstances may control of a corporation be more important than large profits?

How are capitalists compensated for the risk which they incur in financing corporations?

Summarize the methods of securing corporate capital and the sources from which it is drawn.

CHAPTER III

CAPITAL STOCK

1. *Stock and non-stock corporations.*—Capital stock has already been defined as the vested interest which the owners of a corporation have in the company. A share is merely one of the equal parts of the capital stock. The shareholders are the owners of the corporation; in fact, in their collective capacity the shareholders are the corporation, since it can have no existence without them. Most corporations are stock corporations.

Another form of corporation, also composed of individuals associated under a charter from the state, is known as a non-stock corporation, because the interests of the associates are not represented by transferable shares. The interested parties in this case are called members, instead of stockholders. Non-stock corporations are formed for public or mutual benefit, and not for private gain. Contributions are in the form of donations, from which financial profits are not expected nor received. Churches, universities, Young Men's Christian Associations, charitable associations, cemeteries, institutions for promulgating art and civic improvement, mutual benefits, etc., are familiar types of non-stock corporations. Altho an interesting

volume could probably be written upon the methods of raising funds for these worthy purposes, such associations cannot be classed as business companies and their methods of raising funds do not belong to the subject of corporation finance.

2. *Subscriptions to capital stock.*—It is usually desirable, and frequently necessary, that some provision for securing the capital of the corporation be made before the charter is taken out. And yet the corporation itself, until the charter is received, has no existence and no power to contract for capital. This situation is met by employing subscription lists, which may be used either before or after the charter is received.

A subscription to capital stock may be, in effect, a mere promise to take stock after the corporation is chartered, or it may be a contract between the corporation and the subscriber, or between the subscriber and trustees who are acting for the proposed corporation, as the case may be. The laws of some states vest authority in certain state officials to act as trustees in receiving stock subscriptions for the benefit of corporations which are about to be formed. Such subscriptions immediately become as binding as any other contract, because the trustees have legal capacity to contract.

In the case of subscriptions to the stock of corporations not yet formed, when trustees are not acting, the subscriptions take the form of a mere promise or continuing offer, which cannot be enforced at law

until the corporation has filed its certificate of incorporation or received its charter, after which the offer becomes a binding contract between the subscriber and the corporation. Under most state laws the offer is automatically canceled upon the death of the subscriber, or if he becomes insane, and may be canceled by him at any time prior to the incorporation of the company. In view of this regulation, which applies quite generally, it would seem advisable, from the financial standpoint, to secure the charter of the company as soon as possible after the subscription books are opened.

3. *Form of the subscription.*—Lists or books—prepared for the purpose—known as subscription lists, may be used for subscriptions, or the subscriptions may be entered on separate cards for convenient filing.

Altho subscriptions may be taken by telephone or telegraph and are as binding orally as other forms of contract, it is always advisable to have oral subscriptions confirmed by letter, or signature on the prescribed form, in order that indisputable evidence of the subscription may be on file. The subscription should always be signed and show in printing, or preferably in the handwriting of the subscriber, the date and the actual number of shares subscribed for. Oftentimes, the par value of each share and of the entire subscription is inserted, as a check upon the amount subscribed.

The list should also clearly describe the stock issue to which it refers, and briefly the purpose

of the corporation. No statement should be withheld the omission of which might afterward justify a suspicion of fraud or sharp dealing. If, for instance, the list states that the company is being formed to manufacture automobiles, whereas, in fact, it is chartered to make both automobiles and bicycles, the omission of this fact from the list might enable subscribers to resist effectively the collection of the amount subscribed. Subscriptions cannot be successfully resisted, as a rule, unless they have been obtained by fraud or material misrepresentation on the part of the company or its authorized representative. If the misrepresentation is not of consequence, or is made by one who is not acting authoritatively in receiving subscriptions for the company, or is a mere statement of opinion or a prediction, no court will relieve the subscriber of his contract to take the shares.

4. *Advantages of using several lists.*—When lists are employed, oftentimes a number of them are circulated in order that the proposition may be placed before many prospective subscribers without delay. Even in small companies, several lists are sometimes used, one for large subscribers, another for subscribers of moderate amounts, and still others for smaller subscribers. It would be a mistake to present to a possible subscriber for a large amount a list upon which had been entered a large number of small subscriptions. It would in turn discourage the small subscriber in many cases if a list were presented to

him containing a number of very large subscriptions and no smaller ones.

It is customary to head each list with the subscription of some well-known and highly respected citizen, whose signature will lend confidence to the enterprise and serve to induce others to subscribe.

5. *Paying for capital stock.*—Sometimes payments upon stock subscriptions must be made before the corporation is actually chartered. The State of Pennsylvania, for instance, before a charter is granted, requires a certificate to the effect that ten per cent of the authorized capitalization has been paid. In this case, funds are deposited in the bank to the credit of some one who acts as trustee for them until the corporation has been chartered and officers duly elected. If payments are made from this fund before the corporation is chartered, the trustee is liable for the amount personally, unless the corporation subsequently ratifies the expenditures.

Sometimes, the actual requirement of the law is avoided by borrowing funds from the bank, and leaving them there on deposit long enough to file a certificate that ten per cent has been paid in; after that the loan is repaid by checking the funds back to the bank. This, of course, leaves the incorporators responsible, but avoids tying up the cash until required by the corporation. The bank protects itself by making the loan on a demand note to the incorporators, with the verbal agreement that the funds will not be checked out. If a check against the fund should be presented,

contrary to the agreement, the bank will at once call the loan and return the check unpaid. Such subterfuges should be avoided.

After the corporation has once been chartered, the payments upon stock subscriptions of course go directly into the treasury of the company, and may be paid out only by officers, and for corporate purposes, in the usual manner. Once the corporation is formed, subscribers are liable to the amount of the par value of the shares they have subscribed for, or if no par value has been assigned to the shares, as is often the case in New York State, they are liable for the amount they have agreed to pay for the stock, at a stated price per share.

Subscriptions may be paid up at once or by instalments, according to the terms of the contract or the calls of the directors, but in any case certificates marked "full paid" cannot be legally issued until the par value, or stated price per share, has been paid to the corporation. The joker in this legal provision appears in the fact that stock need not be paid for in cash, but in most states may be settled for in other property, or in services, at the option of the directors, who assign their own value to such services or property. Obviously, the placing of an exorbitant value upon them has the practical effect of selling shares at less than par, altho marked "fully paid and non-assessable."

6. *Assessable stock.*—When capital stock has been paid for at par in cash, or in services or property ac-

ceptable to the directors, it is known as "fully paid and non-assessable stock," and this information is printed upon the stock certificate.

It sometimes happens, however, that the corporation does not need its new capital all at one time. This is often the case with mining companies, whose capital requirements depend largely upon the unseen and uncertain deposits of nature, and therefore cannot be accurately forecasted. The capital required and the time when it will be needed cannot be definitely predicted, and yet the company may desire to have its capital all subscribed in advance to insure against the uncertainties of future financing. If the highest estimates are accepted, the task of financing is correspondingly greater, and, in this case, if the shares are issued fully paid, the company may find that requirements have been overestimated and that it has more capital on hand than it can productively employ.

7. *Embarrassment of excess capital.*—The excess capital probably cannot be invested safely and profitably outside the business, even if power to do so exists. Either the funds must lie idle, thus depressing dividends and encouraging extravagant management, or be returned to the stockholders thru a reduction of capitalization, or be employed in a forced expansion of doubtful expediency. Such a situation is likely to discredit the management, tho it is by no means as serious as a shortage of capital. The second United States Bank failed in 1836 from the attempt to find use for its excessive capital, and a number of

modern concerns owe the beginning of their downfall to the same cause. A more chronic difficulty, however, is the shortage of capital. Who ever knew a business man under fifty who was not short of cash?

8. *Difficulties of capital shortage.*—If the lower estimates are adopted and full-paid stock issued accordingly, the company may later find itself embarrassed on account of lack of funds with which to complete the undertaking. The failure to provide adequate capital will then reflect unfavorably upon the enterprise and cause distrust of the management. The stockholders cannot legally be called upon to pay more on their full-paid shares and may not be willing either to authorize or to purchase additional stock. Their distrust will naturally spread to outside investors and to the banks.

Under such conditions, if additional funds are procured at all, it will probably be on most unfavorable terms, such as will permanently injure the credit of the company and discredit the management. The fear of loss easily stampedes the investment and loan market, even if based upon nothing more serious than the failure of the management to estimate correctly and provide adequate capital in advance.

9. *Remedy found in part-paid stock.*—To provide against such exigencies, part-paid or assessable stock is sometimes issued. A typical certificate of full-paid and non-assessable common stock appears upon the following page. The term "assessable stock" means merely that the stock is issued before its full par

Certificate No. 25
For 20 shares.
Issued to
W. H. Walker,
323 Fourth Ave.,
Pittsburgh, Pa.
Dated December 10, 1912.
From whom Transferred,
Original Issue.
Dated Dec. 10, 1912.

No. Original Certificate	No. Original Shares	No. of Shares Transferred

Received Certificate No. 25
for Twenty Shares this
12th day of Dec., 1912.
W. H. Walker.

No. 25 — 20 Shares

Incorporated under the Laws of The State of New Jersey

THE DUQUESNE IMPROVEMENT COMPANY

Capital Stock.....$150,000
Common Stock.....$100,000
Preferred Stock.....$50,000

Full-paid and Non-assessable

THIS IS TO CERTIFY that W. H. Walker is the owner of Twenty Shares of the Capital Stock of The Duquesne Improvement Company transferable only on the books of the Company by the said owner thereof in person or by duly authorized attorney, upon surrender of this Certificate properly endorsed.

{CORPORATE SEAL}

Witness the seal of the Company and the signatures of its duly authorized officers this tenth day of December, 1912.

R. S. JONES, Treasurer.

J. B. SMITH, President.

Shares, $100 each

or stated value has been paid to the company, part being paid at the time of issue and the balance being payable on stated future dates or upon the call of directors. Certain restrictions may be placed upon these calls, as, for instance, the requirement that the directors shall not call more than ten per cent in any one month, but in any event the stockholder is not liable for more than the par or stated value, and the stock becomes full paid and non-assessable when the par or stated value has been paid. The certificates representing assessable stock are supposed to indicate that fact, and may or may not show the amount paid upon the stock or the amount still subject to call. The full par value of the stock may never be called if not required.

The uncertainty of the demands that may be made upon stockholders in the future renders assessable stock unpopular with investors. A stockholder may lose his stock entirely thru inability to meet an assessment, or he may hesitate to pay an assessment, fearing that the condition of the company is unsound. If this fear is justified, to pay the assessment may be only to send good money after bad. And yet there is the hope that additional funds may enable the company to survive. What shall he do, pay or refuse to pay? Only a few weeks before this chapter was written, the writer was under the painful necessity of advising a young man who had purchased ten thousand shares of stock at twenty-five cents a share to forfeit his stock rather than meet another assessment of ten

cents a share which the directors had just levied. In this case investigation proved that the mining company needed an undertaker instead of additional capital. It should be noted that the predicament of the stockholder would have been about as serious had the company been good, but had he been unable to find a market for the shares or to raise the funds required to meet the assessment. Those who do not pay such assessments are usually shut out by judicial sale in favor of a syndicate representing those who do pay.

10. *Paying for stock in instalments.*—Assessable stock should not be confused with subscriptions paid by instalment. The investment of capital funds is a gradual process usually, and the corporation does not require all of its subscribed capital at one time. It may take, for instance, two years to construct and place in operation a steel mill, during which time the construction will be paid for as rapidly as completed. Working capital may not be required until the plant begins operation. Nevertheless, stock subscriptions are taken in the beginning for the full capital, with the intention of issuing full-paid and non-assessable stock. Obviously, gradual payments upon these subscriptions will not inconvenience the company, while investors may be more easily interested if the stock can be paid for out of their incomes on the instalment plan. This is particularly true of small investors, who are afraid of assessable stock but will buy non-assessable shares on the instalment plan. One instance is recalled in which subscriptions were

payable 20 per cent down and 20 per cent every four months.

When payments are arranged on this plan, interest is often allowed on them from the date made until the full subscription is paid and the stock issued, when the regular dividends begin to apply. The better practice, however, is to issue full-paid stock to the extent of each payment as made, the regular dividend rate applying thereon from the date issued, so that the amount of stock issued by the company at all times agrees with the amount received upon subscriptions. When the company desires for some good reason to withhold issuing certificates until subscriptions have been paid in full, interest should be paid at the same rate as the prevailing rate of dividend, if possible; otherwise, at the current rate of interest for short-term notes. The usual reason for withholding the issue of certificates is to support the market for the stock, which might otherwise be broken by a flood of selling offerings interfering with the further collection of subscriptions and the trade credit of the company.

It is becoming more and more the practice of corporations to enlist the interest of their employes in the welfare of the concern by giving them an opportunity to become stockholders. When this is done, subscriptions are usually taken which are payable in small monthly instalments. Interest is allowed on the partial payments, and when the amount subscribed has been fully paid, stock certificates are issued.

11. *Stock notes.*—It appears to be illegal in many jurisdictions for a corporation to accept the note of a subscriber as full or part payment for stock, particularly unless the issue of certificates is withheld until the note has been paid. A note is not payment, but a promise to pay. It can hardly be construed to fulfil the statutory requirement that stock shall not be issued until it is paid for.

If no stock is issued against it, such a note should be entered and considered as a mere accommodation to the company on the part of the subscriber, and not a settlement for stock. The note may in this manner be taken, indorsed and discounted without fear of exceeding corporate powers or violating the law. When it is paid, the accommodation is automatically discharged and stock may be issued.

When such notes are taken in exchange for stock, contrary to the intent of the law, banks with a knowledge of the circumstances should not discount them, for they may prove to be uncollectible. The courts of most states, however, enforce the payment of such notes, and, when stock may be legally issued for property other than cash, the subscriber may apply in payment of subscriptions the notes and bonds of other companies which he owns, if the directors will accept them. The issuance of stock notes is always of doubtful financial expediency because of the legal difficulties surrounding their use.

12. *Treasury stock.*—It is well to indicate at this point the difference between certain terms that are

often confused. The following terms should be clearly distinguished from one another: (1) Authorized Stock, (2) Issued Stock, (3) Unissued Stock, (4) Treasury Stock, (5) Bonus Stock.

The "authorized stock," as already stated, consists of the number of shares, or the total par value of shares, which the company's charter permits it to issue. The issued stock consists of that portion of the authorized capital represented by outstanding certificates. The technical point should be noted that stock which has not been issued may have been paid for. The term, "issued stock," refers to the certificates actually issued, and not to stock subscribed and paid for. But the term, "outstanding stock," more properly applies to the actual amount of stock that has been paid for, whether certificates have been issued or not, since the certificate is not essential to the ownership of the stock. "Unissued stock" is merely that part of the authorized issue not represented by outstanding certificates. Issued stock plus the unissued stock equals the authorized stock. It is customary for paid or outstanding stock to be issued immediately.

Unissued stock is frequently confused with treasury stock. Treasury stock consists of shares which have been paid for and issued by the corporation and have come back into the possession of the company by purchase or gift. In most states companies are permitted to buy their own shares and to receive their own shares in gift. Unissued stock can be sold only by the corporation for its par value in cash, property

or services. But treasury stock may be sold at any price, or given away, if desired, since it has already been once legally paid for and issued. Treasury stock, as we shall see, is frequently acquired by the corporation at a nominal price from promoters who have purchased it originally from the company in exchange for greatly overvalued property or services. Having been legally issued in this manner as full-paid stock, and returned to the treasury of the company, such shares are at the disposal of the officers to be given away with bonds or preferred stock, as an inducement to investors.

When stock is given out in this manner, to assist in securing additional capital, it is called bonus stock. Treasury stock need not necessarily be used for the purpose of paying bonuses, but may be sold for cash to secure working capital.

Unissued stock, on the other hand, cannot be legally given away as a bonus. But note how easily the rule is thwarted. The corporation has power to borrow on whatever terms it is able to procure, and therefore, to sell its bonds at any price. All that is necessary, therefore, to legalize the stock bonus is to offer the stock and bonds together at a lump sum, inferring a discount on the bonds equal to the par value of the accompanying stock. In other words, the amount of stock given with the bonds is treated legally not as a bonus, but as a reduction in the selling price of the bonds. For example, if a company desires to market debenture bonds, and is only able to do so by giving a 25 per cent bonus in common stock, it will legally

accomplish this by selling to the investor $250 in common stock at par and $1,000 in its debenture bonds at seventy-five, receiving in exchange one thousand dollars in cash. This is really giving unissued stock as a bonus, without receiving payment at par, but the books should show that the discount is upon the bonds and not upon the stock, in order that the law may be satisfied.

13. *Transfer of stock.*—After stock has been subscribed, paid for and certificates of stock issued, the holder may desire to sell it. Enough has been said to indicate the general procedure of transferring stock. The subject is of great legal interest, because of the mass of litigation between conflicting claimants. A few of the principles of law which have emerged from this litigation about the negotiability of shares, bearing directly upon the financial plan of the company, require mention.

It is apparent that the more readily negotiable the shares can be made, the more marketable the stock will become. At the same time, it is necessary to safeguard the issue of certificates and to identify clearly the legal owners of stock for the purpose of voting and receiving dividends. Stock certificates may be lost or stolen, no certificates may have been issued for stock fully paid, or several certificates may have been erroneously issued for the same stock. Stock certificates may be forged or counterfeited; in fact, numerous circumstances may arise which make it necessary to have some other and better evidence of stock ownership than the certificate.

In order that stock certificates may be a valuable means of identifying the owner of shares, the law places upon the corporation the burden of issuing and properly recording them. The innocent purchaser of a stock certificate, unless it has been forged, may therefore feel quite certain that the assignment of it places him in position to demand a new certificate in his own name and to have it recorded on the books of the company.

To make this transfer, the original owner of the stock may appear personally and surrender this certificate, authorizing a new certificate to be issued to the new owner, or he may sign a power of attorney, authorizing another whose name is mentioned to appear for him and transfer the stock in like manner. By reason of this signed blank, power of attorney, printed upon the back of the stock certificate, enabling any future holder to insert his own name and have the stock transferred to himself on the books, the certificate becomes highly negotiable, passes by delivery, and may be sold, or pledged as collateral upon a loan, without further assignment.

REVIEW

Describe the methods of securing subscriptions for capital stock, and the obligations which the subscriber assumes.

What are the usual requirements in regard to the payment for stock?

What is assessable stock?

Why is it undesirable that the entire authorized capital be paid in full at the outset?

Describe the instalment plan of paying for stock.

Distinguish carefully one from the other: authorized stock, issued stock, unissued stock, treasury stock and bonus stock.

How is stock transferred?

CHAPTER IV

STOCK NOT PAID IN CASH

1. *Cash payment not the universal rule.*—A careless reading of the incorporation statutes might easily give the impression that the capital stock of a corporation must always be paid in cash. But this is not the case, and a more careful search of the statutes will discover provisions which make it possible to issue stock against property of various kinds, or sometimes services, with the sole qualification that these shall be estimated at their true value. Thus arises a wide variety in the payment of stock subscriptions, some forms of which must be considered.

2. *Paying for assessable stock out of profits.*—When a successful concern has issued assessable stock, and has not called for full payment, the withholding of dividends has the practical effect of paying up the stock, since it relieves to that extent the necessity of calling the balance of the payments, and increases the capital of the company as much as tho regular dividends had been declared and an assessment for a similar amount had been made against the stock. From the accounting and legal standpoint, however, this stock is still only partly paid. The earnings withheld by the company appear on its books as surplus,

and have not reduced the amount still callable on the stock before it becomes fully paid. The surplus may render financial difficulties less likely and, of course, the credit and stability of the company is enhanced by retaining both the surplus and the additional stock liability of subscribers.

But stockholders desire to avoid the uncertainties of assessable stock, preferring the more marketable and less risky full-paid shares. It is therefore customary, under these circumstances, for the company to declare a special dividend equal to the callable and unpaid portion of the subscriptions, at the same time making an assessment of an equal amount to pay up the shares. Stockholders may then take out full-paid certificates and the amount of the dividend is charged to surplus and credited to capital stock account on the books of the company. The effect of this transaction is to pay for stock out of earnings.

3. *Converting profits into stock.*—In a company which has issued only full-paid and non-assessable shares, upon which regular dividends have been paid, the surplus may be similarly distributed in payment for stock by declaring a special stock dividend, which will likewise transfer the credit from the surplus account to the capital account of the corporation. Each stockholder will then receive a new certificate for additional full-paid shares to the extent of his dividend. Thus, if a stock dividend of 25 per cent is declared, the holder of one hundred shares of the par value of one hundred dollars each, will receive a new full-paid

certificate for 25 shares. We shall see later, in the discussion of dividend and capital accounts, the effect of such a transaction upon the balance sheet of the company.

The value of each share of stock outstanding will be decreased about 20 per cent in the above illustration, because there are now 125 shares outstanding against property formerly represented by only 100 shares. But the stockholder may find himself a trifle better off after the stock dividend than before, as the 125 shares will probably have a slightly higher aggregate market value than the 100 shares did before, and the established rate of dividend which he formerly received upon only 100 shares, will now probably be continued on the 125 shares, thus substantially increasing the income and marketability of the stock.

4. *Building up a surplus.*—Paying for stock out of earnings must not be confused with the increase of stock values thru the creation of a surplus. The common stock of the United States Steel Company, for instance, was not paid for directly by its holders out of the earnings of the company, but it has achieved a real value from the accumulation of surplus earnings reinvested in the business. When the stock was issued it represented largely the expectations of future earnings. By good management and a conservative dividend policy the United States Steel Company has increased its assets until the common stock now rests largely upon tangible values in the business.

5. *Paying for stock with property.*—When stock is paid for with property other than cash, the directors may place their own valuation upon the property. If they are bargaining with an outsider, they will of course give as little stock for the property as the owner is willing to accept. If they or their friends control the property, however, and it is desired to water the stock of the company, that is, to issue it without the corporation receiving full money's worth at par, they may do so by assigning an exorbitant value to the property which is exchanged for the stock. The stock will then be issued as full paid, in conformity with law, and may be sold or given away at their pleasure, either by the promoters personally or as treasury stock of the company. This overvaluation of property in exchange for stock effectively nullifies the legal theory that stock cannot be issued unless paid for at par.

Two well-known cases will serve to illustrate the point. When the United States Steel Company was formed in 1901, it entered into a contract with a syndicate, headed by Mr. Morgan, in which it agreed to turn over its securities in exchange for the securities of the ten large steel companies that were to compose the combine and $25,000,000 in cash. Under this agreement, the Steel Company delivered practically its whole authorized capital stock to the par value of $550,000,000 common, $550,000,000 preferred, and also $304,000,000 in bonds, in exchange for $25,000,000 in cash and the securities of ten steel companies. The par value of the United States Steel securities

was perhaps double the actual value of the securities taken in exchange. The common stock represented a capitalization of the anticipated economies of combination; in the expectation, since realized, that increased earnings would enable dividends to be paid on a larger capitalization than had been possible under ten separate and competing companies. Here, then, is an instance in which property, consisting of the securities of other companies, was over-valued in order that full-paid and non-assessable stock of the new company might be issued.

The United States Leather Company, formed in 1893, represents a typical voluntary combination. Without much assistance from outside promoters and by agreement between the companies interested, committees were appointed to appraise the holdings of the various concerns. The consolidated company then paid $100 in common and $100 in preferred, par value, for the assets acquired, based upon the appraisals of these committees. In other words, the company paid for the tannery and bark properties with its preferred stock, giving an equal amount of common stock as a bonus. The capitalization thus overvalued its assets two to one.

6. *Effect of issuing stock for overvalued property.* —If the company has not received money's worth at par for its stock, the creditors, in the event of the company's becoming insolvent, may usually recover from stockholders, by proving the fact that the stock was issued for overvalued property or services, making

allowance in favor of stockholders, of course, for reasonable differences of opinion as to the value of the property or services received. Only the state, or creditors of the insolvent company, may question the transaction, and the lapse of considerable time does not remove their remedy. In many instances courts have assessed, for the benefit of creditors, shares marked "full-paid and non-assessable." Such cases, however, usually arise in companies of small or moderate size in connection with the attempt of promoters to defraud subscribers or creditors for the purpose of securing excessive profits.

7. *Liabilities of directors and rights of subscribers in overvaluation.*—In many states, directors who knowingly issue stock for overvalued property or services may be held accountable to the creditors of the company, if it afterwards becomes insolvent and, in a few states, they may be imprisoned. The modern tendency is to hold directors and officers of corporations personally responsible for all the wrongful acts and omissions of the company. Fining a corporation only results in reducing its profits, thus imposing the punishment upon innocent stockholders. But to imprison or fine officers and directors places the responsibility and punishment for intentional violation of the law where it belongs.

When a subscriber who has really paid for his stock at par, finds that other subscribers have been permitted to pay less, he is entitled to have his subscription canceled and his money returned, on the grounds of

fraud. But if the subscriber has taken stock, and a new stock issue is afterwards sold for overvalued services or property, he has no relief except to prevent by litigation or otherwise the issuance of the new shares. Subsequent issues of stock are frequently put out at a discount, with the consent of stockholders, in order to get much needed additional capital. The innocent holder, who subsequently purchases such stock without knowledge of the circumstances attending its payment, cannot usually be held liable to creditors, since he is entitled to the assumption that the stock which he is purchasing has been legally issued in the first place.

Of course, a contract to buy or sell unissued shares at less than par cannot be enforced, since it is ultra vires on the part of the corporation. If executed on one side, however, the courts will usually compel performance by the other, or a reinstatement of the parties to their original position. Thus, if a subscriber has paid for stock at less than par, under the terms of the contract, and a subsequent officer refuses to issue the certificate, the court will ordinarily compel the company to issue the certificate upon payment of the real balance due, or return the money of the subscriber and cancel his subscription.

Since promoters rely mainly upon watered stocks for their compensation, it is evident that a strict enforcement of the rule that stock must be paid for at par, in actual value, would prevent the promotion of many new enterprises.

8. *Intangible property as a basis for watering stock.*—Patents, trade marks, and good-will are personal property. Intangible assets of this nature possess such uncertain values, that directors are safe in issuing almost any amount of stock in exchange for them. Who would undertake to prove, for instance, that the patent processes and good-will of the ten steel companies, whose control was acquired by the United States Steel Company, were worth less than the half billion dollars par value in common stock issued for them? The law permitted the Steel Company to acquire the stock of other companies, and the directors of the Steel Company were under the necessity of fixing a price upon the value of the shares to be acquired. A large part of this value arose from the possession of intangible assets of problematical value.

9. *Capitalization of patent rights.*—No one can foretell the value of a patent. A new invention may at any time be superseded, or it may be annulled in court for infringement. The protection which it affords is limited by law to seventeen years, and its value as a patent expires with this protection. The entire value of a patent, and oftentimes of the capital investment required to exploit it, disappear when the protection afforded by law ceases.

It is plain that the value of any patent actually depends upon the profit which results to the company from its use or possession. The cost of acquiring, protecting and exploiting the patent are elements influencing its value, and the shorter its period of life

the smaller will be the product and the greater will be the unit cost of production. Therefore, any time lost in taking advantage of a patent, or time and money lost in establishing its validity, or fighting infringements, materially affects its value as an asset. These factors cannot be foreseen, and no one, therefore, knows the value of a patent.

One of the world's greatest inventors, who has since died, a few years ago patented a device and organized, to exploit it, a company capitalized at $1,500,000, practically all the stock of which was issued to him for the patent. The company then succeeded in borrowing $100,000 working capital from a bank. The only real capital of the concern consisted in the borrowed money, and upon this beginning a small and fairly prosperous business has been erected. And yet in the city of Pittsburgh, three men of mechanical genius, but limited means, have perfected and patented a similar device, superior in every way to that of the great inventor, but having, as yet, no financial backing. What is the relative value of these two patents?

In the one case a bank, with almost criminal carelessness, loaned $100,000 of its depositors' good money upon the strength of a patent which had not yet demonstrated its success and which is now superseded by a better device. The loan was really based upon the reputation of the inventor and the bold front of a prominent attorney. On the other hand, the invention of the three mechanics, altho now several years

old and rapidly approaching expiration, has represented nothing but expense and trouble to them, the difficulty being that they are themselves financially unable to produce and market the device and yet are unwilling to sell at a sacrifice price to those who have adequate capital. No patent, as a rule, can be marketed for a large sum until it has been thoroly demonstrated, and these three gentlemen are not able to invest the capital required to properly demonstrate their invention. As each year elapses, their expense grows greater, and the value of their patent becomes less. The capitalization of patented processes, unseen natural resources and good-will at excessive values is the most ordinary form of "painless dentistry" used to extract safely the savings of the unwary.

Secret processes are even a poorer basis of capitalization than patents. Not only is a process subject to all the risk of a patent, except the time limit of its existence, but it is likely to be divulged and thus lose any special advantage the company had thru its use. Being secret, investors have no way of judging in advance the value of the process, except by the output, and it may be discovered too late that a process has been capitalized which has never existed, or which is nothing more than a matter of common knowledge in the industry.

10. *Valuation of good-will.*—The good-will which attaches to a trade name is of more definite value than either patents or trade processes, but even here the same inability to measure value is apparent. How is

any one to tell whether the success of an established concern has been due to the superior management of certain men connected with it, or whether the good-will attaches to the concern itself? Many cases could be cited in which the withdrawal of a single individual from an established business has resulted in practically wrecking its good-will within two or three years.

One instance is recalled in which an established and successful company, making annual profits between $40,000 and $60,000, or at the rate of from 20 to 30 per cent upon its capitalization, was practically wrecked in five years by an incompetent new management. And yet the good-will of this business had been capitalized in combination at more than $300,000. Under the old management, never less than 10 per cent had been paid on this inflated capitalization. Under the new, the trade-name was soon dropped and dividends almost ceased. Some questions are of interest here. Was the good-will overvalued at $300,000? If not, what salary was the old manager worth, and what salary the new? Was the good-will personal or corporate?

The capitalization of intangible assets, such as have been mentioned above, formed the basis of the stock watering operations of the industrial trusts, and of the enormous profits which the promoters of those trusts were able to secure. The safest way apparently to overcapitalize a company is to assign an extravagant value to intangible assets which are exchanged

for securities. The only test of the value of such assets is found in their probable earning power, and this is so uncertain that rarely can a capitalization based upon it be successfully attacked in the courts.

The matter of a good-will and its place in the balance sheet is still the subject of periodical discussion in Canada. A large industrial company of the Dominion for years carried good-will in its balance sheet at $1,000,000. The item was reduced to the nominal sum of $1. This was the company's explanation:

> A recent appraisal of the company's properties, made by competent valuators, established their real value at over $2,000,000 in excess of the figures at which they were being carried on the books of the company; and the directors therefore felt justified in adding $830,304.03 of this excess to property accounts. This, with $169,694.97 transferred from the profit and loss account, enables the company to write down the item of $1,000,000 for good-will, trade marks and patent rights to the nominal figure of $1.

In valuing good-will or other intangible assets of companies, it is noticeable that there is a greater difference in such valuations than is found in the valuation of physical assets. Allowance must be made for differences of opinion in estimating values.

REVIEW

Explain the process of paying for stock out of profits.
Explain how building up a surplus enhances the value of stock.
How is capital stock issued without adequate consideration?
How does intangible property figure in overcapitalization.
Explain the use of good-will as a basis for capitalization.

CHAPTER V

TRADE CREDIT AND BANK LOANS

1. *Corporate loans and liabilities.*—Corporations can secure capital only by gift, the sale of capital stock or borrowing. The borrowing may take any one or more of numerous forms. The chief means by which corporations can borrow are:

Trade credit
Short-term bank loans or discounts
Long-term notes
Bonds

This classification is a broad one used to analyze the motives underlying the various types of corporate obligations. Any form of loan constitutes a liability and should appear as such upon the company's books. On the other hand, the capital stock of a corporation does not represent a liability, for the reason that it is not a debt. The stock, nevertheless, to the extent actually paid in, stands on the liability side of the balance sheet to represent the investment of the owners in the corporation. This is termed "stock liability." By accountants, it is called an "accountability."

When, for the purpose of obtaining cash, a corporation discounts at the bank, notes which it has received from customers in settlement for goods or services sold, or, when the company assigns its accounts receivable, the transaction is more in the nature of a sale of assets than in the nature of a loan. It is customary, in such cases, however, for the corporation rediscounting or selling its accounts or bills to guarantee or indorse them, thus assuming an indirect or contingent liability. Such contingent liability should be noted on the company's statement, but is not found on the balance sheet. This fact is often overlooked in compiling or analyzing corporate statements for credit purposes. A contingent liability often develops into a real debt, tho it may not appear in the balance sheet.

2. *Why corporations borrow.*—Why do corporations borrow? Why create a debt, which must be repaid with interest, when the sale of additional stock would bring funds permanently into the business without a fixed liability for interest? The reasons are:

1. That capital stock in many corporations does not attract investors and cannot be advantageously sold
2. That general market conditions often preclude the sale of stock (as during panic or depression)
3. That new capital is often required for only temporary or seasonal purposes which do not justify securing additional permanent capital

4. That present stockholders profit more by borrowing at a low rate and investing at a higher yield than by increasing the stock capitalization.

Oftentimes the company's record of earnings is so poor, or the risks of the business so great, that common, and even preferred stock, cannot be sold to advantage; and yet the same company, by pledging assets on hand, may be able to borrow on fairly good terms. If, for instance, a market could not be found for seven per cent preferred stock above 80 per cent of par, but the corporation could pledge assets which would enable it to borrow on bonds at the rate of six per cent, it is plain that financial advantage to the present stockholders would accrue from borrowing, in so far as it could be done safely.

This thought lies at the heart of the financial plan in determining the character of the capitalization. To illustrate, let us take a company having outstanding one thousand shares of common stock, total par value $100,000, and one thousand shares of seven per cent preferred stock, par value $100,000. Presuming that this company is earning ten per cent, the preferred stock will be receiving regular seven per cent dividends, leaving $13,000 annually available for distribution to common stockholders, or 13 per cent dividends.

If, now, this company desires to extend its business by the addition of $50,000 new capital, the holders of common stock, who control the company, will

have three methods to consider: the sale of common stock; the sale of additional preferred stock; the sale of six per cent mortgage bonds. Let it be assumed that any or all of these may be sold at par and that the earnings of the company are sufficiently stable to insure the regular payment of interest upon the bonds and dividends upon the preferred stock. Granting that the new capital earns the same profit for the company as the old, the net earnings available for interest and dividends will now be $25,000 each year instead of $20,000.

Distribution if bonds are issued:

Earnings,		$25,000
Bond interest,	$3,000	
Preferred dividends,	7,000	10,000
Common stock, 15% on par,		$15,000

Distribution if additional preferred stock is issued:

Earnings,	$25,000
Preferred dividends,	10,500
Common stock, 14½% on par,	$14,500

Distribution if additional common stock is issued:

Earnings,	$25,000
Preferred dividends,	7,000
Common stock, 12% on par,	$18,000

It is plain that the common stockholders profit by issuing bonds rather than preferred stock, or preferred stock rather than common, because the new

capital earns more than the interest or preferred dividend rate. This principle always holds true when earnings upon new capital are higher than the interest paid for loans, and are regular enough to insure the continuance of interest payments in good times and bad. By assuming the marginal risks of the enterprise, the common stockholder is able to retain, either in the increased value of his stock or in the declaration of dividends, the entire earnings of the business above the fixed interest paid upon loans and the fixed dividends upon preferred stock.

3. *Use of trade credit.*—Practically all business concerns borrow in some form or other. Many concerns have no bonds outstanding and others borrow nothing from the banks or from the public upon notes, but practically all utilize trade credit as a source of capital.

Trade credit consists in the delivery of goods or services to the customer upon the express or implied promise of future payment. It is usually in the form of the sale of merchandise on time, the credit appearing either as an open ledger charge on the books of the seller, verified by the shipping documents, or in the form of a promissory note or trade acceptance, executed by the customer in favor of the seller. In either case, the obligation falls due upon a specified date, or within a certain number of days or months from the date of shipment. The obligation may bear interest at the current rate. If the seller draws on the buyer for the amount of the invoice, and the draft is accepted by the purchaser, it becomes a trade ac-

ceptance. The transaction ceases to be an account receivable on the seller's books. It may be carried as a "note receivable" along with promissory notes, or which is better practice, be carried in a separate account.

The net result of such trade credit is always to increase temporarily the capital of the customer at the expense of the seller. The customer, to this extent, becomes a borrower; the seller, a lender. Most firms in business make a continuous practice of purchasing largely on time, employing to that extent the capital of others in their business.

4. *Open account as a selling inducement.*—Trade credit, like other forms of credit, is based upon mutual confidence. It is less formal, however, than other forms of credit, especially in the case of the open account. The order for goods perhaps does not state the price or the terms of payment, and the shipment is followed by a mere memorandum in the form of an invoice to the purchaser, stating the usual terms of payment and the cash discount which may be deducted for prompt remittance.

Ostensibly, there is something more behind this form of credit than mere confidence. It is the goodwill which the seller obtains thru this courteous and informal treatment of the customer's business. In other words, trade credit in the form of open accounts may be considered by the seller in the light of capital employed to finance the selling end of the business. It is a form of advertising. This is why it is now so hard for the Federal Reserve Board to reintroduce

into our domestic trade the general use of the trade acceptance, in place of the open account. The open account, promissory note and trade acceptance appear on the balance sheet as quick assets of the seller and as short term liabilities of the buyer.

5. *Advantages of credit instruments.*—When the credit is evidenced by a note or acceptance, the seller may indorse the instrument and discount it at the bank, which amounts to nothing more or less than a sale of an asset of the company and the creation of a contingent liability by reason of the indorsement thereon. The instrument will be purchased by the bank at a discount from its face value, representing the interest which the bank deducts for advancing the funds until the date of maturity. If it is the first time the instrument has been thus sold, it is called a discount; if discounted more than once, the process is called rediscounting. In emergency, as we shall see later, open accounts may be discounted, but in a different manner.

It is customary abroad and in Canada, and in some lines of business in the United States, for the seller to draw upon the purchaser for the amount of the invoice. This draft is presented to the purchaser for acceptance, usually thru a bank. If the purchaser has received the goods in satisfactory condition and is willing to pay the account, he will probably write his acceptance upon the draft. This acceptance has the effect of an acknowledgment of the account and a promise to pay the draft upon presentation in accordance with its terms. The acceptance is then returned

to the seller, who either holds it until maturity and presents it for collection, or discounts it at his bank.

Generally speaking, there is no sounder method of extending the capital of a manufacturing or mercantile enterprise, whether a corporation or not, than by the use of trade credit, especially when in the form of notes and bills available for discount. The term "bill," as here used, means "bill of exchange." In domestic use it is known as a draft, in foreign trade, as a bill of exchange. It is evident that, if any company obtains more trade credit than it, in turn, extends to its customers, it is obtaining to that extent the free use of borrowed capital. This is the first and most advantageous source of corporate borrowing.

6. *How banks assist in extending trade credit.*— Commercial banks cannot properly make loans or discounts except for short periods of time, usually not over ninety days or four months, and this should cover transactions which involve the production and distribution of products or services in the ordinary course of trade.

This is recognized in the Federal Reserve Act, which vests in the Federal Reserve Board the power to define the kind of papers which Federal Reserve Banks may rediscount for member banks. The Federal Reserve Board defined such paper in the following words:

> The limitations relating to rediscount operations, contained in section 13 of the Act, may be divided into two classes: First, those positive limitations under which such notes, drafts, and bills of exchange may be accepted for re-

discount; and, second, those limitations specifically stating what paper shall be excluded.

If we begin with the latter, we find the very clear provision excluding all notes, drafts and bills of exchange which are "issued or drawn for the purpose of carrying or trading in stocks, bonds or other investment securities (except bonds and notes of the Government of the United States)." This clause does not require comment.

The Act further excludes notes, drafts and bills of exchange covering "merely investments."

Any funds employed in agriculture, commerce or industry are quasi investments, and the emphasis is, therefore, to be laid on the word "merely" in this connection.

From this point of view are to be excluded all bills whose proceeds have been or are to be used in permanent or fixed investments of any kind. "Agricultural, industrial or commercial purposes" can not, therefore, be held to include investments in land, plant, machinery, permanent improvements or transactions of a similar nature.

The purchase of commodities for purposes which are merely speculative and not connected with an ultimate process of manufacturing or distribution would constitute a "mere" investment, and bills covering such investments are accordingly not eligible for rediscount.

In order to be eligible for rediscount, bills must "arise out of actual commercial transactions," and "the proceeds must have been used or they are to be used for agricultural, industrial or commercial purposes."

In like manner "notes, drafts and bills of exchange secured by staple agricultural products or other goods, wares or merchandise" are eligible for rediscount provided they arise out of "actual commercial transactions" covering some particular stage in the process of production and distribution.

They are not eligible when drawn to cover merely speculative investments.

It is plain from the above why notes and acceptances arising in the extension of trade credit constitute the finest possible investment for commercial banks. To the seller they are much safer and quicker assets than open accounts by reason of this bank demand.

7. *Trade credit not used for permanent investments.*—Trade credit should not be depended upon, however, to provide funds for permanent investment, as in lands, buildings and machinery, for the simple reason that such assets cannot well be sold to liquidate the credit when due. Trade credits are nearly always for short periods and are ordinarily expected to be self-liquidating; that is, the buyer is expected to convert the goods into cash in time to pay the open account, acceptance or note which he assumed when he purchased the goods.

Just to the extent that transactions involving trade credit are not self-liquidating, the buyer is compelled to make payment out of funds procured from one or more of the following other sources:

Profits of the business
Bank loans
The sale of bonds
The sale of capital stock
Sacrifice sale of assets.

No business can be expected to make money rapidly

enough to pay for permanent assets out of profits earned during the brief interval for which trade credit is ordinarily granted. Neither is it usually safe to depend upon the anticipated sale of stock and bonds to meet trade obligations. It takes time to authorize, issue and sell securities, and the trade credit of any concern should not hang upon such a slender possibility as an emergency sale of securities. Pending the sale of security issues, which have been previously authorized and their sale provided for, trade credit or bank loans may sometimes be relied upon to finance permanent investments. As a principle of finance, however, it is a risky practice to depend upon trade credit or bank loans to finance such investments, or even unusual seasonal requirements, unless the company has remaining a liberal excess of quick assets over its short term liabilities.

Bank loans are also short term obligations which are expected to be self-liquidating and repaid when due, and to refund a trade credit out of the proceeds of a bank loan is much like jumping from the frying pan into the fire. The commercial banker is usually more exacting than the trade creditor, and any continued reliance upon him to supply funds for permanent investment invites calamity.

8. *Trade acceptance versus the open account.*—We have seen that the seller who extends credit upon promissory notes and trade acceptances is in a position to convert them quickly into cash by discounting

them at the bank. This keeps the seller's capital free for productive effort, enables him to do a larger business by turning his capital more often, and by extending to purchasers longer credit than he would be able to extend out of his own limited resources. In the intangible form of an open account, on the other hand, this trade credit could not be rediscounted at the bank. It is clear, therefore, that if the commercial banks are to do their part in financing trade transactions, the credits will have to be evidenced by tangible credit instruments, such as the negotiable note and bill of exchange. The general adoption of these instruments in trade will result in a more effective use of the credit machinery of the country. There are many sound economic reasons why the trade acceptance should supersede the open account in general use.

Resulting from the unsound practice of selling upon open account, we have evolved a system of commercial and bank credit, based largely upon guesswork, curtailing the just accommodation of smaller companies and fostering the unscientific and wasteful cash-discount system.

The trade acceptance is the principal instrument of settlement in all foreign trade and in the domestic trade of foreign countries. The foreign trade of the United States is conducted principally upon this basis, and so was our domestic trade until the disturbing influences which followed the Civil War led to the general adoption of the open account.

9. *Economic advantages of the trade acceptance.*— What are the economic advantages of the trade acceptance over the open account?

In the first place, the resumption of giving and rediscounting trade acceptances would restore to the banks their proper function of financing trade credits, liberating that much of the seller's capital for other productive uses. In the second place, it would lead to the more generous extension of credit to small deserving companies, which are often discriminated against by the present system. In the third place, it would lead to sounder and more discriminating methods of commercial banking by placing bank discounts upon a more self-liquidating basis, tending in turn to increase profits, lighten the reserve requirements and decrease the number of failures among commercial banks. It is common knowledge that most commercial banks which fail are found to have a liberal share of their assets locked up in permanent loans, which would not have been possible in the discounting of two-name trade paper.

In the fourth place, the definite due date of the trade acceptance, and the knowledge that it must be paid in full when presented by the bank, would tend to prevent overbuying and other similar loose practices on the part of the purchaser. And lastly, the trade acceptance would tend to abolish cash discounts, since the conditions which were chiefly responsible for introducing them will then have ceased to exist.

HARRISON BROS. & CO., INC.

PAINT COLORS VARNISH WHITE LEAD CHEMICALS
35TH AND GRAYS FERRY ROAD

PHILADELPHIA

The new *Federal Reserve Banking Act* provides for discounting "trade acceptances" at minimum rate. These are drafts drawn by seller and accepted by purchaser, and bearing evidence that the draft represents an actual delivery of goods.

All other great nations have long possessed this system, the lack of which has been a prominent cause of the monetary stringencies which often afflict the United States, and now that our government has adopted the plan, it is not only a financial advantage but a civic duty for American business houses to forward it.

Taking advantage, for our mutual benefit, of this provision of the Federal Reserve Act, we are able to offer you, instead of the terms stated on the enclosed bill, special terms for *accepted draft, in attached form.*

If you wish to avail yourself thereof, please accept the enclosed draft by signing and filling in the name of your Bank in the blank provided, across the face of the draft, and return it to us promptly in settlement of the enclosed invoice. Otherwise terms will remain as stated on the face of the invoice.

HARRISON BROS. & CO., Inc.

$..... Philadelphia,.....19..

.....after date pay to the order of

HARRISON BROS. & Co., Inc.

..... Dollars

in settlement of our invoice of.....19..

To ..... } *HARRISON BROS. & CO., Inc.*

..... } *by .....Cashier*

Across the face of this trade acceptance is stamped the following:

The obligation of the acceptor of this bill arises out of the purchase of goods from the drawer.

Accepted, payable at the .....Bank

Encouraged by the example of other countries, and the policy of the Federal Reserve system and aided by all well-informed merchants and bankers, it is not too much to predict the early and general adoption of the trade acceptance thruout the United States. On the preceding page is reproduced a form letter typical of those which hundreds of modern concerns are sending to their customers in the effort to assist in this great and much needed reform.

10. *Extent of trade credit.*—The extent to which any company may safely receive trade credit depends directly upon its size, financial condition, and the nature of its business.

Generally speaking, the amount of trade and bank credit combined which may be extended to any company with safety is determined by the ratio of its liquid assets to its short term liabilities. The current income should be sufficient to meet all operating expenses and take care of such trade and bank credits as they mature. Liquid assets include everything which, within reasonable certainty, may be converted into actual cash within a few days or weeks. Cash, accounts receivable, finished stock awaiting shipment on existing orders and all other standard products or securities on hand which have a regular market for immediate sale are liquid assets.

This does not include the securities of subsidiary companies or of allied industries, the continued control of which is important to the integrity or success

of the business. Such securities, it is true, may be quite salable or easily pledged to secure additional loans, but should not, in the writer's opinion, be classed as quick assets for the purpose of determining the safe extent of trade or bank credit. Securities of this type are really a part of the capital investment. Trade credit and bank loans can properly be asked to finance current operations only, in the ordinary course of production and distribution. In determining the ratio of current assets to current liabilities, only those assets should be included as current which are being continuously converted into cash by the transaction of current business. On this basis, it is usually safe to carry current liabilities equal to 75 or 80 per cent of the quick assets.

Trade credit is not obtained on advantageous terms when the concern, by so doing, acquires a reputation for slow pay or loses the benefit of cash discounts much larger than the prevailing discount on bank loans. If the proper relation is maintained between liabilities and quick assets, neither slow pay nor loss of big discounts results. Credit is often injudiciously extended on mere amount of assets, whereas only cash will pay the obligation. Therefore, only *quick* assets are good cover for current liabilities. Lack of appreciation of this simple fact has caused the unnecessary failure of many business corporations and banks.

11. *Bank loans.*—What has been said about trade credit applies largely to bank loans. Both are for the

purpose of financing current operations, and this is really the true purpose of a commercial bank.

The more important functions of commercial banks are, or should be, to receive deposits and discount trade notes and acceptances, both of which arise essentially out of commercial transactions. These instruments are two-name paper, and usually self-liquidating; that is, backed by the actual existence of salable merchandise on its way to the ultimate consumer.

Most bank advances in the United States, however, have not been of this kind, since the borrower has financed his customers on open account, in turn selling his own note direct to the bank, bearing on its face no evidence of the use to which the funds were put. Added security is often given to such notes by the signature of an indorser or the pledge of collateral.

It has been customary in the United States to make such bank loans on the general standing and reputation of the borrower, altho frequent losses have gradually led to the introduction of statements to enable the banker to judge the credit risk more intelligently.

Under our present system of bank loans in the United States, any successful manufacturer may go to the bank and borrow funds to gamble on the stock market, play the horse races, live extravagantly, or send his boy to college. None of these are proper commercial loans, and perhaps none of them, not even the last, is productive. But the bank and its depositors do not know what the borrowed funds are

being used for. This could not happen if customers' notes and trade acceptances were discounted. These instruments would evidence the nature of the transactions out of which they arose.

Every bank should insist upon, and every borrower should willingly furnish, especially under the American system of accommodation loans, a complete, detailed and sworn annual statement, upon which the borrower's credit for the ensuing year may be judged. This practice is being gradually introduced in the United States.

12. *Growth of Canadian industries.*—The rapid increase in the number of industrial and other corporations in Canada in recent years has materially extended the relations of Canadian banks and corporations. In a recent year, 4,651 new companies with a total authorized capitalization of $1,245,000,000 secured Dominion or provincial government charters. By the postal census of manufactures, taken in 1916 for the previous year, it was shown that capital of $1,138,000,000 was employed in manufacturing, being an increase of 134 per cent over the capital employed in 1905. These figures indicate to some extent the heavy bank financing involved.

13. *Financing new industries.*—Sir Edmund Walker in testifying before the Banking and Commerce Committee of Ottawa in 1913, was asked whether it were good banking to advance money on securities of new enterprises pending the sale of bonds, and replied that not only was it proper to do so but that

industries could not be established unless this practice were followed.

Complaints are sometimes made in the Dominion that funds belonging to communities are drawn to monetary centers and there used as loans to underwriters, promoters and others. But many of the large factories or industries could not have built up unless the facilities of financing the underwriting operations had been available.

Speaking on "Banking in Canada" before the London Institute of Bankers some years ago, Sir Edmund Walker, president of the Canadian Bank of Commerce, said:

> . . . our policy is to lend by established credits only the money necessary to produce and carry the merchandise to market. Now if a customer deals with only one bank, pays for all materials and labor in cash, makes all payments by checks on his bank, exhibits his balance sheet and profits, and at the same time discusses at length the various features of his business for the purpose of having his credit reestablished, it is not difficult to lend him very large sums with safety. In addition to the analysis of the balance sheet, comparisons are made with several for previous years . . . all except the quite small credits are discussed with the boards of directors.

14. *Purposes of short-term loans.*—Enough has been said to indicate the true purpose and safe extent of short term borrowing, whether from trade credit, bank loans, or the sale of short-term obligations to the public. This latter class of notes will be dealt with in another chapter. Before leaving the subject

of bank loans, however, a review of the specific purposes for which they may be made is necessary. Exceptions may be taken to this list, or additions made to it, but in general it will be found correct:

(a) To produce, ship, store, sell and collect for the regular product of the business, when there is reasonable certainty of turning the transaction in time to repay the loan.

(b) For current or capital expenditures pending the receipt of funds from the sale of stock or bonds which have been underwritten, and the proceeds of which are expected in time to liquidate the temporary loan.

(c) To carry unusual seasonal stocks, production or accounts receivable which will ordinarily be liquidated in time to repay the loan or amply secure its partial renewal.

(d) To pay dividends which have been earned but are temporarily locked up in assets that will be normally liquidated in time to repay the loan.

To illustrate; a corporation was formed with an authorized capitalization of $500,000, of which $200,000 was seven per cent cumulative preferred, the balance common stock. The promoter subscribed the common stock and paid for it in cash at par. He was a successful business man, highly rated, and enjoying at the banks perhaps the highest personal credit of any man in the community. The purpose of the new company was to manufacture and sell unfermented grape juice.

The plant was built and equipped at a cost of $250,000, out of funds provided by the sale of the common stock. The preferred stock was relied upon to furnish working capital. It was sold to New York parties who agreed to take it up and pay for it the following September in time to purchase the grapes for the fall pressing.

When the time came to deliver the preferred stock, it was found that the underwriters had suffered reverses which rendered it impossible for them to take the stock. Something had to be done quickly. If the grapes were not purchased and pressed within the next thirty days, the plant would have to lie idle for an entire year, awaiting the next crop. These funds could only be provided by the sale of the preferred stock, by the sale of bonds, by the issue of corporate notes or by short-term bank loans.

The plant was situated in a country town and consequently had but little bonding value. Furthermore, the original financial plan did not contemplate the issue of bonds, and there was neither time nor desire to resort to them. The issue of corporate notes was not feasible under the circumstances. It was impossible to sell the preferred stock in the short time remaining. Local bankers were consulted and agreed to advance the required funds pending the sale of the preferred stock so that the company could go ahead with its operations. Among others, a trust company in New York City advanced $50,000. The plan was to renew the loans for ninety days upon maturity, pay off half at the second maturity, and the balance ninety

days later. It was calculated that the company could do this out of current income, meanwhile selling the preferred stock to secure its permanent working capital.

Before reading the next paragraph, how many readers see the flaw in the plan thus far?

Everything progressed well until almost time for the second renewal. Then the trust company failed, and the Banking Department of New York State, which took charge of the bank, refused to renew. Meanwhile, the preferred stock had not been sold, but the business of the company was better than had been anticipated. It became plain that the banks would not only have to renew again for the full amount as agreed, but carry the share of the trust company as well. This they refused to do unless given control of the company pending the repayment of their advances. An actual audit and inventory was then taken by certified accountants engaged by the bankers which showed an excess of $185,000 in assets above all liabilities, after writing off ample depreciation upon goods and accounts and the entire value of a good-will which had cost $100,000, and which had resulted in sales aggregating half a million dollars in five months.

Now in control, the bankers preferred themselves as creditors by the issue of bonds, by a process described elsewhere in this Text. Their next step, was to secure the appointment of two of their number as receivers. A few months later the business, which the bankers themselves had valued at $185,000 above

all liabilities when they took charge, was wound up by the payment of six per cent to general creditors.

The flaw in the plan is now clear. The concern should have refrained from opening the plant until the following year, utilizing the interval to sell the preferred stock. The case is cited in detail to illustrate the danger of relying upon short-term bank loans for capital that should be obtained from the sale of securities, and to illustrate a frequent fate of business concerns which fall into the hands of the banks.

REVIEW

What are the chief forms of corporate liabilities?

Why does a corporation prefer to borrow rather than to issue new stock?

How is trade credit employed in the operations of corporations?

Explain the advantages of the trade acceptance over the open account.

What determines the amount of trade or bank credit which a corporation can obtain?

For what purposes may these forms of credit be properly used?

What were the errors in promotion that led to the difficulties of the Pennsylvania manufacturing corporation referred to in Section 14?

CHAPTER VI

SHORT-TERM LOANS

1. *Short versus long-term loans.*—In the legal sense a note and a bond are the same, each being a written promise for the future payment of money. In finance, however, different meanings are given to these terms, based upon distinctions of: (1) time, (2) formality of contract, (3) denomination, whether singly or in series, and (4) security.

We have seen that corporate notes may be (1) given to trade creditors to cover purchases, (2) discounted at the banks for seasonal advances, or (3) sold to the public for temporary requirements. When given to trade creditors or banks, they are usually self-liquidating and do not run over four or six months. When sold to the public, however, notes usually run from one to three years, and sometimes longer. Bonds, on the other hand, usually run from ten to one hundred years, seldom less than five years. This chapter relates to notes maturing in from one to ten years and sold to the public, including banks which buy in the open market.

Notes are sold to fill temporary requirements, whereas bonds are issued to supply a part of the permanent capital of the company. Bond issues are

therefore usually larger than note issues, better secured, and the instruments are more formally drawn. Notes may be given singly, as in the case of bank loans or the settlement of trade accounts, but when sold to the public are usually in series. When so issued, each note is for one hundred dollars, or some multiple of this sum. When issued singly, the note may be for any odd amount, according to the account settled or the specific amount borrowed. Notes in series differ from bonds, which are always issued in series, only in being issued for shorter terms and with less formality.

It is only natural that long-term obligations should be better secured and more formally evidenced than temporary and smaller debts. Notes issued individually or in small series may be very informally written and may range in denomination up to $100,000 or larger. On the other hand, when the issues are of large size and expected to be widely sold to the public, it is better practice to have the notes beautifully engraved, and issued much in the same style as bonds. In this case, they are usually in even denominations of one hundred dollars, five hundred dollars, or one thousand dollars, and may be listed upon the stock exchange.

Corporate notes, whether large or small, formal or informal, single or in series, always mature upon a definite date and otherwise conform to the requirements of negotiable credit instruments. Each note should be signed by the proper officer of the corporation, upon whom authority has been expressly con-

ferred and should bear the name of the corporation above the signature of the officer, in order that it may not be mistaken for his personal obligation.

2. *Market for corporate note issues.*—Since corporate notes are sold to meet temporary requirements, they are put out upon a banking basis, that is, they bear a rate of interest similar to trade obligations, or direct bank loans, and possess security similar to that required by banks upon ordinary accommodation paper. It is usual for the corporation in turn to retain the right of redemption upon any interest date, after short notice, and frequently, when reinforced by collateral, the right to substitute or redeem any part of the collateral deposited under the trust agreement.

The ordinary investor in bonds who desires maximum security, permanency of investment, and minimum supervision over his investment does not favor corporation notes. Their short term, redemption on brief notice, the care required to examine and watch them, and the possibility of idle funds between investments render them unattractive to him. On the other hand, commercial banks do not purchase them widely because they are too long in term, too restricted in market and not liquid enough. This explains why such notes usually require a higher interest rate than bonds. A slight difference in interest rate and marketability is often the only noticeable distinction between long-time collateral trust notes and short-time collateral trust bonds. In some cases, the difference between them is merely nominal.

3. *Effect of world war on market.*—The market for such obligations has been limited, tho corporate notes have been growing rapidly in popularity since the outbreak of the European war. They have been purchased in the past mainly by investment bankers and certain large private investors, who have funds temporarily idle and who are glad, pending other permanent investment, to receive the five or six per cent interest which such notes bear instead of the lower rate obtainable from the bank deposits or bonds. During the war, yields on such loans have ruled between six and eight per cent.

Since the outbreak of the World War, financing in this form has become quite general, both in the United States and Canada, altho of very recent adoption in the latter country. Government issues of long-term notes, known as treasury notes or treasury bills, have long been issued by various nations, including the United States. Many commercial banks have, within the past few years, invested for the first time in such obligations, because the interest rate on prime commercial paper was low, money plentiful and the bond market uncertain during the first two years of war. During this period, bond prices were low, due largely to the tremendous new issues of foreign government bonds at high interest rates. When the United States finally began hostilities after nearly three years of forbearance, money rates rose rapidly, owing to the vast demands of government financing; and the market for corporation notes suffered curtail-

ment along with all other private issues. The education of investors in the purchase of corporation notes will be a valuable help to future corporation financing, but contains elements of danger that will presently be pointed out.

Altho corporation notes have been sold by note brokers in the same manner as the sixty and ninety-day obligations of large corporations are sold to outside banks, they are at the present time mainly marketed thru large investment bankers, who underwrite the issues or undertake their sale in much the same manner as bonds are underwritten and sold. The principal business of the note broker is to sell the thirty, sixty or ninety-day paper of commercial organizations to banks and to some few private investors, who prefer to invest their surplus funds in the more liquid form of commercial paper than in bonds.

4. *Operations of note brokers.*—Perhaps an account of the operation of note brokers should have been included in the chapter dealing with bank loans. In brief, it may be stated that they either purchase outright and sell at a profit, without indorsement, the commercial paper of large companies, or else market this paper upon a commission basis. Their clients consist mainly of bankers, who, thru the constant investment of surplus funds, become acquainted with the credit of these large companies, altho having no direct banking connection with them. Such commercial paper is usually not secured by collateral and bears the current rate of interest on accommodation

loans. The sales usually are made by personal call by the broker or his representative upon the banker, the broker displaying his collection of paper, or duplicates thereof, for the inspection of the banker, who selects the pieces which he desires to buy. Settlement is made then and there, or upon receipt of the original, if the banker has purchased from a duplicate.

The operation of note brokers, while conferring certain benefits by the more active distribution of idle funds, has not been altogether advantageous. By scattering notes broadcast instead of selling them thru their own direct bank connections, some corporations have been able to obtain current credit out of all proportion to the amount they are entitled to receive. One concern in Boston which failed a few years ago, was found to have notes outstanding aggregating several times its entire assets, these notes having been distributed by brokers as far West as St. Louis and even thruout Canada.

It is probable that the active use of the credit files of the Federal Reserve system, in cooperation with state bank examiners and clearing house associations, will minimize the dangers of the practice of distributing commercial paper thru note brokers, at the same time retaining the benefits accruing therefrom. It should be noted that the evils of this practice arise entirely from the discount of accommodation paper, and would not be possible if the discounts were in the nature of trade acceptances or the notes of customers rediscounted in the open market.

5. Advertising sale of corporate notes.—In order that the operations of note brokers in selling commercial paper may not be confused with the sale of corporation notes, which, for the most part, are marketed like bonds, we have reproduced below an advertisement from the *Commercial and Financial Chronicle* announcing the sale of the notes of the Shawinigan Water and Power Company. The advertisement illustrates clearly the nature of the issue and the way in which its sale is announced to the public. Most large issues of corporate notes are now marketed by bond houses and announced in this fashion.

$2,500,000

THE SHAWINIGAN WATER & POWER COMPANY

Province of Quebec

Two-Year 5% Secured Gold Coupon Notes

Closed Issue

Dated October 2, 1916 **Due October 1, 1918.**

Interest payable April 1 and October 1 at New York Trust Company, Trustee, New York, without deduction for taxes of any nature imposed by any taxing authority in Canada. Notes in denominations of $1,000 with privilege of registration as to principal. Callable in lots of not less than $500,000, at 101 and int. on any interest date upon 30 days' notice.

(Here follows a brief account of the capitalization, business and affiliations.)

IMPORTANT FEATURES OF NOTE ISSUE

1. **Notes are the direct obligation of the Company and are followed by $15,000,000 of capital stock upon which dividends at the rate of 7% are now being paid and having a value at present market of about $20,000,000.**

2. Notes are secured by deposit with the Trustee in New York City of bonds and stocks with a value at present market of over $3,350,000. The market value of these securities, under the terms of the indenture, shall at all times be at least 25% in excess of the face value of notes outstanding.
3. Earnings for the past ten years have continually increased.

	1906	1915
Gross earnings	$362,396	$1,920,143
Net earnings, after operating expenses taxes and all fixed charges	81,305	1,169,032
Required for 5% interest on this issue of notes		125,000

NET EARNINGS FOR 1915, AFTER ALL CHARGES WERE NEARLY TEN TIMES INTEREST CHARGES ON THIS ISSUE OF NOTES

Price 99¾ and Interest, to Yield 5⅛%
Descriptive Circular on Request

CURTIS & SANGER, 33 Congress Street, New York Boston Chicago
CHASE & COMPANY, 19 Congress Street, Boston
STONE & WEBSTER, 147 Milk Street, New York Boston Chicago

This advertisement appears as a matter of record, all the notes having been sold.

6. *Corporate notes versus savings deposits.*—If the investor were to hold his funds in bank, as a checking account, many of the stronger banks would not pay him any interest; in fact, in the writer's opinion, he would not be entitled to any. Some banks, however, particularly trust companies, will allow two per cent on deposits subject to check.

Savings banks, paying three or four per cent in-

terest, usually require ample notice of withdrawal, leaving the funds no more liquid, if as much so, as they are when invested in good six per cent notes.

The time notice required by savings banks is often evaded by borrowing the amount needed from the same bank, or another one, assigning the savings account as collateral to the loan. The loan in such a case usually bears six per cent interest and matures on the same day that the time limit on the savings account expires, the latter being merely transferred to the bank's account to liquidate the loan. In most cities, the banks have agreements among themselves, sometimes in the form of a clearing house restriction, not to loan on savings accounts or waive the time limit. When money is easy, however, and banks are not earning much on their interest-bearing accounts, they will usually be willing to waive the time limit, or else loan against the savings account.

The loaning is more to their advantage than waiving the time limit and is therefore more frequently used as it retains the savings account intact and enables the bank to make a six per cent loan with perfect security. Even if his funds at four per cent can be had by the depositor without notice, there is much to commend the temporary investment in six per cent notes instead. In the first place, the yield is probably fifty per cent greater on the notes, six per cent or more against four. In the second place, if savings-account funds are procured without notice, the bank either deducts all the interest, or allows interest only to certain

even dates. If a temporary loan against the account is made, the bank charges six per cent on the loan, thus absorbing the entire advantage to be gained by removing the funds and reinvesting them at six per cent. In other words, the customer is borrowing his own money and paying the bank two per cent on it until the savings-account notice expires.

It should be remembered, however, that corporation notes are ordinarily issued in quantities only during times of a shortage of long-term capital. At such times bond yields are high as a rule, the banks have good opportunities for profit on their interest-bearing accounts, and are therefore loath to release them without notice. For these reasons, investment bankers and large private investors, having surplus funds awaiting future use, to an increasing extent are preferring corporation notes over interest-bearing savings accounts.

It may be asked, why not invest such funds in good active stock-exchange securities, which may be sold at any time, instead of in notes which have but a limited market? Many do this with their idle funds. Others, however, in an increasing number, prefer the corporation notes, in spite of their more restricted market, because of their higher yield and the fact that they do not fluctuate much in value on account of their rather early maturity. Bonds are subject to market fluctuations and do not in ordinary times yield over four or five per cent upon the safer issues. Moreover, corporation notes are rapidly achieving a broader use

and more active market. They may now be classed as a standard type of investment security.

7. *Security behind corporate notes.*—Long-term notes, when issued in series and sold to the public, are usually secured by the deposit of collateral with a trustee, under a trust agreement protecting all note holders. This is particularly true of large issues. Large individual notes, or smaller issues in series, however, frequently have no lien security pledged behind them.

Railroad companies and other large companies usually have the stocks and bonds of subsidiaries available for collateral. Even strong companies like the Pennsylvania Railroad, whose general credit is unquestioned, follow the practice of depositing such collateral behind their notes, for the purpose of improving their marketability. There is little or no difference in such cases between these notes and short-term bonds. Sometimes mortgages or leases are deposited with the trustee, when collateral in other forms is not available. The increasing popularity of short-term notes is due largely to the growing practice of placing definite lien security behind them. This is done to attract bond investors, who are accustomed to specific security, and who are not willing to loan on general credit because of the difficulty or impossibility of obtaining and analyzing a correct statement of the company's affairs.

When corporate notes are not reinforced, their value rests upon the general credit of the company,

which depends in turn mainly upon the surplus earnings above fixed charges. When these notes mature, whether secured or unsecured, they are expected to be paid and not renewed, because they are a temporary expedient, employed to bridge over a seasonal demand or a period in which bonds cannot be sold to advantage. They are not expected, except temporarily, to take the place of permanent financing. Instances could be cited in which such notes have been refunded by new issues of the same kind. Such instances, however, do not illustrate the general practice, as the notes are usually retired out of the current receipts from seasonal business, or by the sale of bonds.

It is customary for corporations to announce the purpose for which such notes are sold. An element of great strength is added if the proceeds are to be invested in the business in a productive capacity, so that the new liability is offset by proportionately increased productive assets, increasing the income more than enough to pay the interest upon the notes. Frequently a series of notes will be marketed for the purpose of cleaning up a variety of current obligations, making needed repairs, and replenishing the cash account of the corporation. In such a case, they are not looked upon as favorably as tho the proceeds were to be invested directly in the business to increase its output or capacity.

It is plain that anything which increases the net earnings of the company improves the security behind the notes, whether collateral is pledged or not. This

is particularly important when no specific collateral is pledged to secure the loan. It is a distinct sign of financial weakness when notes are issued to retire current or other maturing obligations, the company at the same time not possessing enough liquid assets to secure adequately its notes with collateral. This brings us to the next topic, the purposes for which such notes may properly be issued.

8. *Purposes for which corporation notes may be sold.*—Within recent years a number of large railway companies have been forced into receivership by the maturing of their notes at inopportune times. This suggests the danger of such short-term financing and also the principal purpose behind it.

Long-term notes are ordinarily used only to finance other maturing obligations or new capital expenditures at a time when bonds cannot be advantageously sold. During 1914 and 1915, for instance, while bond prices were low and declining, many maturing corporate obligations had to be met and, at the same time, new capital provided for increasing production caused by war orders and unusual business activity. Many millions of dollars worth of long-term notes were sold to provide necessary funds until the bond market should recover and render permanent financing possible upon a normal basis. These issues mature mainly between 1917 and 1920. In most cases, the normal profits of the business cannot be relied upon to repay them at maturity.

If these notes should happen to mature during a

depression, when permanent financing is still impossible and business dull, or during war while capital is scarce, no doubt many of the companies will be seriously embarrassed to refund or pay them off. With the United States in the war such embarrassment appears very likely at the time this is written. If the notes are refunded at all during such conditions, it will be at higher rates of interest or with greatly increased security. A renewal of maturing notes is considered a sign of financial weakness and almost always reflects upon the credit of the company. For these reasons, only the strongest companies should enter upon the policy of temporary financing of this kind, if any other course lies open.

Let us illustrate the use of such notes. Ten selected railroad bonds were sold in 1909 at an average price of 101.6, to yield 4.15 per cent on the investment. In other words, these roads could borrow on bonds in 1909 at 4.15 per cent interest. In 1915, these same bonds were selling at 89, and yielding about five per cent to investors at that price. In other words, a thirty-year bond, based on these actual averages, would cost in interest 30 times .85 per cent, or 25.5 per cent more, during the life of the issue, if sold in 1915 than if sold in 1909.

Suppose now that a railroad, with credit equaling the average of these ten, had bonds maturing in 1915 which it desired to refund for thirty years. Payment could not be postponed and yet the market, as above indicated, was unfavorable to new issues. Perhaps

the managers figure that by 1920 conditions again will be as good as in 1909. Setting aside our personal opinions, and assuming their estimate to be correct, it would cost, during the life of a thirty-year bond, 25.5 per cent more interest to sell the bonds in 1915 than to postpone the issue until 1920. Under these conditions the road will sell its five-year five or six per cent notes, maturing in 1920, for the purpose of paying off the bonds maturing in 1915. When these notes mature in 1920, it is planned again to sell bonds at 4.15 per cent interest for the purpose of paying off the notes.

The note interest would be about one per cent higher than bond interest for five years, leaving a net gain over the entire period of about twenty per cent from financing temporarily by notes and awaiting a better bond market. Perhaps the same collateral will be deposited behind the notes as behind the maturing bonds. This example illustrates the purpose which actuated many companies to sell notes in 1914, 1915, 1916, and 1917.

9. *Dangers in the use of corporate notes.*—Summarizing what has previously been said, it appears that corporate notes should not be offered to the public or to the banks without observing the following principles:

1. They should be issued only as a temporary expedient.

2. Unless self-liquidating, or covered by a large surplus of quick assets, they should not be issued ex-

cept in premeditation of the reasonably assured sale of stocks or bonds, out of the proceeds of which the notes can be retired.

3. If possible, in order to insure their sale upon the best terms, the notes should be issued serially and secured by the deposit of collateral with a trustee, with provision for substitution of collateral within reasonable limits and with privilege of redemption at a stated price upon reasonable notice.

4. Interest paid should not greatly exceed the rate it would be necessary to pay if it were to borrow on a new issue of bonds.

Interest is usually semi-annual, but may be quarterly or annual. It may be payable on specific dates to registered holders, or by coupon, as in the case of bonds. The stated interest rate never exceeds six per cent, and rarely runs as low as five per cent. If a higher yield than six per cent is demanded, it takes the form of a discount on the selling price of the note. Thus, a three-year note which must yield seven per cent to attract investors will bear six per cent interest and sell at about 98. Rarely more than seven per cent is paid on strong issues.

The trust agreement under which secured notes are issued does not vary greatly from that of collateral trust bonds, which will be fully described in a later chapter. The actual wording of corporation notes varies with the circumstances of issue, with the amount of the issue, security pledged, purpose of issue, form

of interest payments, methods of sale, credit of the company and other similar considerations.

10. *Short-term loans in Canada.*—While short-term loans have been comparatively common during recent years in the United States, it was not until the years 1912 and 1913 that they commenced to appear as an important factor in Canadian finance. At that time, too, the issues of such securities by United States corporations were unusually numerous. Canadian provincial governments and municipalities were among the first to utilize this method of financing. In 1913, the movement spread to the Canadian railroads and both the Grand Trunk and the Canadian Northern Railway Companies made such issues. Since then, and especially after the outbreak of the World War in 1914, a large volume of short-term loans has been issued by industrial corporations and others. This form of financing seems to be particularly popular in times of financial stringency.

The tendency in Canada has been to retire short-term notes, whenever possible. Certain Canadian industrial companies, as well as many in the United States, made exceptional profits in 1915 and 1916, thru war orders. The Canadian companies vigorously maintained a policy of retiring their short-term obligations out of these profits. The Dominion Steel Corporation, for example, paid off in cash on December 1, 1916, £700,000 of 6 per cent notes maturing on December 1, 1918. The company's debts to the banks having been already liquidated, the balance of

the cash had accumulated by the beginning of that month to proportions sufficient to allow payment of the five-year notes which represented the last of the corporation's short-term obligations.

A short time previously the Lake of the Woods Milling Company of Montreal announced the retirement of $750,000 of maturing bonds which it had guaranteed for a subsidiary company. On a smaller scale the same policy of strengthening working capital, thru liquidation of floating debt or accumulation of liquid resources, has been put in force by numerous other industrial concerns in Canada, and the cumulative effect has placed Canadian industry generally on a stronger financial basis.

REVIEW

Distinguish between the short- and long-term loans of corporations.

Why have short-term notes been issued so frequently in recent years?

Describe the activities of note brokers.

What attraction do short-term notes hold for the investor?

On what security are they commonly issued?

For what purposes are short-term notes issued?

Explain the dangers of issues of this character.

CHAPTER VII

MORTGAGE BONDS

1. *Long-term loans.*—We have seen that trade credit and short-term loans may be safely relied upon only for working capital, or pending the assured sale of permanent securities. In any event, they must be well covered by liquid assets.

Permanent or fixed assets, unless secured by the sale of capital stock, may safely be obtained only by the issue of bonds, either simple or reinforced obligations. Usually, the bonds are issued in series, in a formal manner, under seal, and are reinforced by a pledge of specific assets.

Whereas short-term obligations are issued to obtain liquid assets or working capital, it is obvious that long-term loans are ordinarily offset by capital assets, that is, by assets in the form of plant or productive equipment. Working capital, or current assets, consists mainly of articles intended for resale, whether in the raw state, in process of production, or the finished product. Capital assets, on the other hand, consist of things which are not intended for resale, but which are utilized or consumed in the processes of production, as stated in Chapter II.

2. *Classification of bonds.*—The following classification of bonds is not exhaustive, but is sufficient for our purpose. They may be classified [1] according to:

1. The character of the issuer—under this heading may be found the following principal types:
   - (a) Railroad bonds
   - (b) Public utility bonds (not including railroads)
   - (c) Municipal bonds
   - (d) Industrials
   - (e) United States government bonds
   - (f) State government bonds
   - (g) Miscellaneous bonds, including timber, land grants, irrigation, levee, drainage, real estate, etc.

2. The purposes of issue
   - (a) Purchasing or consolidating properties or companies
   - (b) Construction and making extensions
   - (c) Improving
   - (d) Unifying, refunding or consolidating other issues.

3. The privileges and conditions of payment or transfer
   - (a) of principal

Convertible bonds

[1] This classification differs essentially from any heretofore published within the writer's knowledge, except as to the classification of bonds according to security, which conforms to that given by Chamberlain in his admirable book, "The Principles of Bond Investment."

Redeemable bonds
Callable bonds
Serial bonds
Registered bonds
Negotiable bonds
Sinking fund bonds

(b) of interest
Coupon bonds
Registered bonds
Income bonds
Participating bonds
Profit sharing bonds

4. Their security
(a) Simple obligations
Plain bonds
Debenture bonds
Long-term notes
Certificates of indebtedness

(b) Reinforced obligations
Bonds secured by guarantee
Assumed bonds
Guaranteed bonds
Indorsed bonds
Bonds secured by lien, on
1. Personal property
Sinking fund
Equipment
Paper collateral (known as *collateral trust bonds*)

Stocks
Bonds
Mortgages
Leases
Certificates of interest

2. Realty, according to:
   Character of the property mortgaged
   Priority of the lien.

Typical names of bonds are in italics in the above classification, but no attempt has been made to present an exhaustive list. Bonds secured by mortgages upon real estate, for instance, appear under thirty or forty different names, which sometimes tend to conceal inferior liens. Such titles as "general and first mortgage bonds," "first and refunding mortgage bonds," etc., are apt to be misleading, as the first mortgage may cover only a very small portion of the property.

Obviously, any classification of bonds according to the character of the issuer is merely for convenience in studying the market movements of each class. It is only by watching the average market condition of each type that the relative desirability of any one issue may be ascertained. The bonds in each of these general classes possess certain typical characteristics, but with varying grades of risk and income.

The classification of bonds as to purposes of issue is of very little value, except that by indicating a

productive use for the new capital, the marketability of the bonds may be somewhat improved.

Classification according to the privileges and conditions of payment or transfer is valuable because each such characteristic bears directly upon the marketability of the bond and indicates a very definite right or restriction to the holder. One desiring to borrow, for instance, will prefer a negotiable bond, payable to bearer, passing by delivery and with interest coupons attached. The investor with a little sporting blood in his veins may prefer the convertible bond, sacrificing a little present safety for the prospect of future speculative profits. The investor desiring a permanent and undisturbed income, with safety first, will not care for a redeemable bond, which the issuing company may pay off on short notice, compelling him to seek another investment. This merely illustrates the importance of classification.

3. *Classification according to security.*—Classification of bonds according to security is more complex. Security is the fundamental requirement of bondholders, who sacrifice income for safety. The reader should note carefully the distinction between security and collateral. A mere promise to pay is security, and there is no such thing as an unsecured bond, altho that term is frequently used to indicate a bond having no pledge of specific assets behind it. A mere signature is called personal security, and depends upon the personal honor or ability of

the signer, whether he be the direct obligor, guarantor, or indorser. We shall see later that guarantee security may be either weak or strong, according to the wording of the guarantee.

There are *good* and *bad* securities of all types and this "quality of mercy" therefore has nothing to do with any classification.

A reinforced obligation is merely one which has security additional to the signature of the original obligor. It may be of real or personal property. This classification is therefore valuable as indicating to the investor the character of the assets which protect him. The term "sinking fund bonds," for instance, implies that, in addition to the signature of the obligor, personal property in the form of a sinking fund has been or will be set aside to insure the payment of the obligation. Equipment bonds, whether called by that name or car-trust certificates or car-trust bonds, indicate that personal property in the form of equipment of some kind has been pledged.

The most usual form of bonds reinforced by lien upon personal property, however, is the collateral trust bond, which name indicates that certain paper instruments evidencing property rights have been deposited as specific collateral to strengthen the promise of the obligor. These will be discussed in more detail later, the principal purpose of this chapter being to describe mortgage bonds, secured by a lien on real estate.

4. *Mortgage bonds.*—Personal property may be

moved, lost, stolen, destroyed or consumed. Real estate, however, is quite permanent. The working capital of a corporation is constantly changing; whereas, the real estate, consisting of land, buildings and fixed equipment, changes but slowly and does not frequently pass from one owner to another. Moreover, the supply of land is limited, and it is of fairly stable value. Real estate, therefore, is considered the best ultimate security.

Real estate is pledged by means of an indenture known as a mortgage. In form this is a deed from the borrower to the lender, or to a trustee representing the lenders, containing a proviso that the instrument shall become null and void if a certain sum, the amount borrowed, is repaid with interest within a stated time. The borrower, however, retains the possession and use of the property, and never loses control of it if his obligations are promptly met, so that in effect the mortgage is considered a lien, rather than a deed. A lien is a conditional deed or transfer of property.

With such a mortgage in hand, the bond holder may, in case of default, by the legal process known as foreclosure, take possession of the real estate, in whole or partial satisfaction of his claim. Usually certain days of grace, notice and other elements of protection are extended to the mortgagor by law and by the terms of the mortgage itself.

The corporate mortgage differs in no essential particular from the instrument given by the individual borrower who gives a mortgage upon his home. The

individual gives his mortgage directly to the lender, probably accompanied by a bond for twice the amount. The corporation, however, may have its bonds distributed among many holders, and it would not be convenient or practicable to divide the mortgage lien among them individually. This necessitates the intervention of a trustee to hold the mortgage in the interests of all the bondholders and to see that the protection accorded by it is exercised for their equal benefit. This is accomplished by mortgaging the property to certain individuals, or to a trust company, as trustee, who assumes his duty under a contract, called a deed of trust.

5. *Deed of trust.*—A deed of trust is, in effect, a contract between two or more parties, by which certain individuals or a trust company are appointed trustees to hold certain property which is conveyed in the instrument to them, and to conduct certain business stated in the contract. From this fact, the instrument receives its name—deed of trust. The trust agreement and the deed may be separated, but are usually one indenture.

In the case of corporate bonds secured by lien on real estate, this deed takes the form of a mortgage, included in the same indenture as the declaration of trust. Since the trustee is a third party, acting between the mortgagor and the bondholders, the contract becomes a three-cornered one. The company is interested in retaining the undisturbed use of its property and securing a reconveyance of it upon pay-

ment of the bond. The bondholders in turn are interested in having the property held subject to the satisfaction of their lien, and free from loss or depreciation meanwhile. The trustee personally is interested in the faithful discharge of his trust, the avoidance of any personal liability, and the receipt of reasonable compensation for his services. The deed of trust must contain provisions which will accomplish all these purposes. Its form and contents will be considered in greater detail in the following chapter.

6. *After-acquired property clause.*—That portion of the deed of trust which constitutes a mortgage for the protection of bondholders, must contain certain provisions beyond those merely creating the lien upon the property. Bonds are usually for long term; property itself is subject to constant change in value, and neither the bondholders nor their chosen trustees can closely watch the security.

Moreover, the company may desire from time to time to extend its plant, or to dispose of certain portions of it, and a way must be left open for doing this. If the proceeds of the bond sale are invested in new property which does not come under the mortgage, instead of in extending, improving or maintaining the mortgaged property, the margin of safety to bondholders will decrease with time.

In order to safeguard the bondholders and at the same time leave the company sufficient freedom of action, a clause is often inserted in the trust deed providing that all the property stipulated, as well as any

property thereafter acquired by the company, shall be subject to the lien of the mortgage. This is known as the "after-acquired property clause." We shall see later that it often embarrasses future financing, and is frequently evaded by interposing a lease or a subsidiary company, under which new property is acquired without subjecting it to the mortgage. Here is a typical after-acquired property clause:

> Together with all the structures . . . (description of mortgaged property inserted) . . . and generally all and singular the estate real and personal of the said —— Company, whatsoever, now owned, *or hereafter to be acquired by it.*

7. *Open mortgages.*—When a corporation is growing rapidly, and needs constantly to enlarge its capital by borrowing, the fact that its best assets are subject to the lien of a mortgage may render it difficult to borrow further on favorable terms. This is particularly true when the presence of the above clause prevents the new extensions or improvements themselves from being pledged under a new mortgage to secure additional funds. It is therefore customary, in financing railroads, and occasionally other companies, either to provide a bond reserve or to execute an open mortgage, under which additional bonds may, from time to time, be issued to meet new capital requirements.

When the property is valuable enough to sustain a mortgage beyond the immediate amount required, the company frequently mortgages the whole property

and authorizes upon this security, an issue of bonds much larger than is immediately needed. These unissued bonds, available for sale at any time for new capital, or for pledge as collateral for temporary loans, constitute a bond reserve for financing future extensions.

When, however, the property is not adequate to create a satisfactory bond reserve, or future extensions are contemplated beyond the amount of such reserve, and cannot be financed on separate mortgage because of the after-acquired property clause, it is customary to employ an open mortgage. A closed mortgage is one under which a fixed amount of bonds may be issued and which carries no lien protection beyond that amount. An open mortgage is one which does not fix in advance the exact extent of the lien or the amount of the bonds that may be issued under it.

The open mortgage always restricts the bonds issued under it by requiring the maintenance of an adequate margin of safety in the value of the property above the par value of the bonds outstanding. The trustee is instructed not to permit the issue of additional bonds, unless this margin of safety is maintained, and certain definite requirements are imposed to insure this being done. The following are the more customary safeguards surrounding the open mortgage and usually several of them are found in the trust deed:

(a) Investment of the entire proceed from the sale of bonds in the productive property or equipment

covered by the mortgage, or to retire maturing prior liens thereon.

(b) No additional bonds to be issued while the floating debt exceeds a certain amount or a certain proportion of the total liabilities.

(c) No additional bonds to be issued unless the earnings available for fixed charges have averaged for a certain period of time a certain excess above the interest requirements, including interest upon the contemplated new issue.

(d) New bonds not to be issued above a certain maximum amount, or a certain amount each year, or a certain percentage of the actual value of the plant.

(e) No property to be sold without turning in to the trustee the full proceeds, or a certain portion thereof, to offset the reduced security, or to retire a portion of the bonds.

(f) Maintenance of adequate reserves against depreciation, usually upon some stated basis.

Open mortgages are rare. A bond reserve serves all the purposes of a limited open-end mortgage, and stands in better favor at the present time. Both require rigid restrictions of similar nature. The after-acquired property clause is now the general rule, especially in the large refunding mortgage issues of American railways, which are showing a strong tendency to clear away the numerous small underlying mortgages and to provide ample bond reserves. It is clear that the bond reserve plan, especially if property is not adequate to secure the entire authorized issue in the beginning, must carefully restrict

floating indebtedness and the investment of new funds in non-producing assets and provide against depreciation.

8. *Junior lien bonds.*—It frequently happens that property covered by mortgage increases in value enough to justify an increased loan against it. The first mortgage holder, however, has a lien upon the property which cannot be superseded. If any further loan is to be secured by a mortgage on this property, the new mortgage can cover only the equity above the lien of the first; in other words, it becomes a second mortgage. In form and protection, it is exactly like the first, with the same remedies at law, and a lien ahead of any general creditors or later mortgage claimants. It may be deposited with a trustee to secure an issue of second mortgage bonds under a deed of trust having substantially the same provisions as the first trust deed.

Second mortgage bonds, third mortgage bonds, or other bonds secured by liens which do not have a first claim against the property are known as junior lien bonds. The only difference between them and prior lien bonds, which lie next to the property, is that they cannot enforce their claim against the property until the prior liens are satisfied in full. Junior lien bonds, in turn, come ahead of all general creditors, while the property lasts. Yet back of the general creditors are the stockholders.

Sometimes the issue of prior lien bonds is very small, as compared with the value of the property,

and second mortgage bonds then become practically as safe as firsts. Junior liens, however, are most frequently used in refunding operations and to effect consolidations. General mortgage bonds are becoming the prevalent type in American railway finance, containing provisions for refunding the old underlying first, second and third mortgages outstanding on certain portions of the property. This pyramiding of mortgages arises thru the natural growth and consolidation of properties already subject to prior liens. For copious illustration, let the reader look up, in *Moody's Manual,* the capitalization of the Erie Railroad, the Southern, the Rock Island and others.

When consolidations are formed, new working capital is always required, and very frequently new permanent capital as well. The properties being consolidated may all be subject to outstanding mortgages. The equity may be sufficient, however, to justify additional bonds. In this case, it is usual to authorize a large issue of first and consolidating or first and refunding mortgage bonds, large enough not only to pay off the existing prior liens as they mature, but also to supply the additional capital needed. The issue will be secured by a first mortgage perhaps on some minor portion of the property, and will be subject to all other existing liens as to the rest. As rapidly as prior mortgages are retired the refunding mortgage becomes a first lien, until finally there remains but the one big general first mortgage secured by all the property.

The prior lien obligations may be retired by selling the new issue and, with the proceeds, purchasing the prior lien bonds in the open market. Or a bond conversion plan may be resorted to under which the holders of prior lien bonds may surrender them in exchange for new bonds. Or sufficient reserve of the new bonds may be held to retire the old bonds as they mature.

If the bond conversion plan is adopted, the owners of prior liens will have to receive some inducement in the price or yield of the new bonds to cause them to exchange. This may be accomplished by a slightly higher interest rate, or by trading in the new bonds at a slight discount, or by extending to them some advantage in control or marketability not possessed by the older issues.

Altho mortgage bonds are preferred by specific security, consisting ordinarily of a lien upon a producing asset, it should never be forgotten that, in the last analysis, their real value rests upon the earning power of the mortgaged property. Junior lien bonds, and even debentures, having no specific security at all, are often better investments than first mortgage bonds which are apparently well secured. Realization has thus aided in recent years the strong tendency of the American railways to simplify and consolidate their bond issues, by refunding underlying liens with general mortgage bonds, which at the same time provide adequate bond reserves.

In the case of a railroad, built up by the consolidation of smaller divisions each subject to the lien of

various mortgages, if the bondholders should foreclose and come into possession of the properties, they would find themselves unable to make a profit operating the various divisions separately. Probably no one of the divisions would have complete facilities, and each would have to depend upon the others to some extent. Under such circumstances the main advantage of the mortgage lien is to take the property out of the hands of the stockholders and place it under control of the bondholders, pending a reorganization which will put the road upon an interest earning basis. Liens in this case are not utilized to deed the property to creditors, but to effect a reduction of fixed interest charges by compelling a reduction in the amount of the outstanding junior liens, or by scaling down the interest rates or priorities of existing issues. Following is a typical form of mortgage bond:

No..... $1,000

UNITED STATES OF AMERICA. STATE OF OHIO

THE COLUMBUS CONSOLIDATED STREET RAILROAD COMPANY

FIRST MORTGAGE TWENTY YEAR FIVE PER CENT GOLD BOND

For Value Received, THE COLUMBUS CONSOLIDATED STREET RAILROAD COMPANY, a corporation organized and existing under the Laws of the State of Ohio and operating street railroads in the City of Columbus, promises to pay to the Central Trust Company of New York, Trustee, or to the bearer or registered owner hereof, ONE THOUSAND DOLLARS, in gold coin of the United States of America, of the present standard, on the first day of July, 1909, and to pay interest thereon at the rate of five per cent per annum from the first day of July, 1889, on the first days of January and July in each year, on the presentation and surrender of the coupons hereto annexed as they severally become due, until said principal sum shall be paid, both principal and interest of this bond being payable at the agency of said Railroad Company in the City of New York. (This bond is subject to redemption on or after July 1st, 1894, at 110 per cent of the par value thereof, with accrued interest, out of a sinking fund of $22,500 a year, beginning

with that date as provided in the mortgage herein described.) This bond is one of a series of Eight Hundred bonds, of like tenor, date and amount, numbered consecutively from One to Eight Hundred, both inclusive, and amounting in the aggregate to Eight Hundred Thousand Dollars, which are all equally secured by a mortgage of said Railroad Company in the nature of a conveyance in trust, dated July 1st, 1889, and duly recorded, conveying all the property and franchises of said Railroad Company to said Trust Company, in trust for the benefit of the holders of said bonds, to all the provisions of which mortgage this bond is subject. In case of default for six months after due demand in payment of any interest on any of said bonds, the principal of all thereof may be declared due, as provided in said mortgage. The principal of this bond may be registered on the books of said Railroad Company at its said agency, and registration thereof noted hereon, after which no transfer thereof shall be valid, except on said books, until after registered transfer to bearer, when the principal of the bond will again become transferable by delivery. The coupons annexed to this bond will always be transferable by delivery. This bond shall not be valid unless authenticated by the Certificate of the trustee of said mortgage.

In Witness Whereof, said Railroad Company has caused its corporate seal to be hereto affixed, and this bond to be subscribed by its President and Secretary, and the name of its Treasurer to be engraved on the several coupons hereto annexed, at the City of Columbus, in the State of Ohio, this first day of July in the year Eighteen Hundred and Eighty-nine.

.....*Secretary* .....*President*

[On the back]

Trustee's Certificate.—The Central Trust Company of New York, Trustee, hereby certifies that this bond is one of of the series of Eight Hundred mortgage bonds, described in the mortgage mentioned herein, bearing date the first day of July, 1889.

CENTRAL TRUST COMPANY OF NEW YORK, Trustee.

By.....VICE-PRESIDENT.

Notice!—No writing on this Bond, except by an officer of the Company.

DATE OF REGISTRY	IN WHOSE NAME REGISTERED	TRANSFER AGENT

(On the end, forty Coupons, numbered on the back, and dated each

first day of January and July, from 1890 to 1909, the face of the first one reading:)

$25. Coupon No. 1.—On the first day of January, 1890, The Columbus Consolidated Street Railroad Company will pay the bearer, at its agency in the City of New York, Twenty-five Dollars, being the semi-annual interest then due on its First Mortgage Bond No.....,

E. K. STENORF, *Treasurer.*

This form will illustrate many of the features discussed thruout the chapter.

REVIEW

What purposes generally dictate the issue of long-term obligations or bonds?

From what points of view may bonds be classified? What is the value of such classification?

Describe the mortgage bond. What is the deed of trust?

What is meant by an open mortgage?

Explain what is meant by junior liens.

CHAPTER VIII

COLLATERAL TRUST BONDS

1. *Use of collateral trust bonds.*—Technically speaking, all bonds which are secured by personal property deposited with a trustee for the benefit of bondholders are collateral trust bonds. In practice, however, mortgage bonds occupy a separate classification, and bonds secured by lease are variously described as equipment trust bonds, car-trust bonds, or car-trust certificates. In ordinary usage, therefore, the term "collateral trust bond" applies only to bonds secured by the deposit with a trustee of the stocks and bonds of other companies.

As a rule, none but holding companies, or large companies owning subsidiaries, are in possession of enough stocks and bonds of other companies to enable them to put out collateral trust bonds. The securities of small companies are not popular, because their market is restricted, and they are not well enough known to possess the public confidence. This is particularly true when the new issue is second to an existing first mortgage. Under these circumstances, when the financing of new construction becomes necessary, the credit of the parent or holding company will be utilized to secure capital upon better terms than the subsidiary could obtain acting alone.

If it is impossible or inexpedient for the parent or holding company itself to issue mortgage bonds, and its guarantee of subsidiary company bonds is not strong enough to carry conviction, collateral trust bonds will be resorted to. The bond in such case will be the general debenture obligation of the large company, with the additional security of stocks and bonds of its subsidiaries, which are deposited with a trustee for the protection of the bondholders. The securities are held under the terms of a deed of trust. The deed is not a mortgage, however, as in the case of real estate, but an actual pledge of the securities as collateral, accompanied by deposit of the securities themselves.

The value of these bonds depends primarily upon the credit of the holding company and only secondarily upon the earnings of the subsidiary, since only in event of default will the pledged securities or their earnings be taken over directly by bondholders. The only advantage of issuing collateral trust bonds, when the assets of the holding company consist entirely of stocks and bonds of subsidiaries, is to average the risk over a number of companies. In such case, the collateral trust bonds will fluctuate widely in price, according to the earnings of the subsidiaries, but will sell at better prices than would the average junior lien bonds of the subsidiaries individually. When the issuing company has a direct income of its own, ample to meet the interest charges without relying upon interest or dividends from subsidiary companies, the

fact that the collateral trust bond does not represent a first lien upon any part of the property may not injure its value greatly. It should be remembered that earnings form the ultimate security of all bonds. When the collateral consists of stock, all the obligations of the subsidiary companies of course come before the security of the collateral trust bond. In such cases it is necessary for the issuing corporation to have an independent income, or for the subsidiaries to have large surplus incomes above fixed charges, if the bonds are to be marketed to good advantage.

2. *Guaranteed bonds as an alternative.*—Sometimes it is desired to market the bonds of subsidiary companies, or directly affiliated companies, with the guarantee of the controlling or parent company. This course is not resorted to as a rule unless the subsidiary company itself has adequate assets and income to protect the issue under ordinary circumstances. Guaranteed bonds are not popular, unless it is felt that the direct obligor will be able to meet the interest charges, and that the indorser or guarantor is to be relied upon only in the event of emergency. Sometimes individuals may guarantee bonds of corporations, as in the case of the Virginian Railway the bonds of which were guaranteed by Mr. H. H. Rogers.

Guarantees are given only when some direct advantage in interest rate or price is to be obtained, and this requires that the guarantor corporation be of the first rank. The guarantee is only considered as

a contingent liability of the guarantor. Very often it occurs that prior bond issues limit the further borrowing power of a corporation, so that the only way it can utilize its credit for new funds is to guarantee the obligations of the subsidiary companies, or buy on lease. Ordinarily, a large company that is free to borrow will prefer instead to put out its own obligations, secured by the deposit of the stocks and bonds of its subsidiaries, in the form of collateral trust bonds.

The fact that the contingent liability of an indorsement is often difficult and expensive to enforce, the legal remedy of the holder consisting in a suit against the indorser or guarantor, is a strong objection to this type of security. It is also apparent that the unlimited use of the guarantee may jeopardize the solvency of the indorser or guarantor, especially when the income of the guarantor depends largely upon the receipt of dividends or interest from the subsidiaries whose obligations are guaranteed. This latter practice merely pyramids credit without affording any real additional protection, and constitutes an unsound financial expedient. The value of an indorsement or guarantee may, of course, be protected to some extent by limiting the contingent liability of the indorser, or guarantor, say to a certain percentage of its capital and surplus.

3. *Forms of guarantee.*—Corporate guarantees may be strong or weak, according to their wording. The indorsement or guarantee of a corporate bond has

the same significance as the guarantee upon a promissory note, the guarantor merely assuming the contingent liability of paying the obligation if the debtor fails to do so. If the guarantee goes further than this, the guarantor may become a direct obligor, protected only by his right to recover from the borrower whose obligation he guaranteed. This might be called an "assumed bond," the clause reading about as follows:

> The Blank Company, of New York, for value received, hereby assumes and agrees to pay the principal and interest of the within bonds as the same shall respectively become payable.

The weak guarantee, on the other hand, contemplates no action on the part of the guarantor, except to insure the bondholder against ultimate loss in the event the obligor defaults. The following form is typical:

> The Blank Company, for value received, hereby guarantees to the holder of this bond the prompt and punctual payment, according to the terms thereof, of the principal and interest, and further guarantees to the said holders that the sinking fund instalment provided in the mortgage and deed of trust and in said bond referred to shall be made in the manner and to the extent therein provided.

In this weak form, the guarantor does not himself assume the obligation. In the strong guarantee, however, the guarantor agrees to make payment at once if there is a default. Following is a typical form of strong guarantee:

The Blank Company, for value received, hereby unconditionally guarantees to the owner of this bond the payment of the principal and interest thereon, as the same matures and falls due, and hereby agrees himself to immediately pay the said principal and interest if any default occurs in the payment thereof.

4. *Features common to the deed of trust.*—All forms of corporate bonds or notes, issued in series and sold to the public, other than plain debenture obligations, require the deposit of collateral with a trustee for the equal protection of those who hold the bonds or notes. It is the transfer to the trustee of this property, or instruments evidencing property rights, together with the usual declaration of trust, which gives to the indenture its name "Deed of Trust."

The form of the property pledged determines the special provisions which must be inserted in the trust deed to protect the interests of the corporation and the bondholders, and to outline the duties of the trustee. Certain features, however, are common to practically all deeds of trust, whether the security deposited with the trustee is in the form of a mortgage upon real estate, stocks and bonds of other companies, or a lease. If the security is real estate, the deed becomes a mortgage, as we have already described in detail in the preceding chapter. If stocks, bonds or leases are deposited, the granting clause merely vests these in a trustee as a pledge of collateral, and the obligations are known as collateral trust bonds.

Exclusive of any special features, however, the

usual form of the deed of trust contains the following provisions:

1. Date and names of parties.

2. The preamble, giving a full statement of the legal status of the corporation, including the state in which it is incorporated, the amount of its capital stock and bonds, and a description of its assets, reciting the authority given by the stockholders and directors for the bond issue, and the specific purpose of the issue.

3. Full text of the bond; the interest coupon, if it is a coupon bond; and the trustee's certificate of validity, which appears on each bond. A typical form of trustee's certificate and the blank for recording registrations of the bond appear immediately below in connection with the new collateral trust bond of the American Telephone and Telegraph Company.

UNITED STATES OF AMERICA
STATE OF NEW YORK

$1000.00 $1000.00

AMERICAN TELEPHONE AND TELEGRAPH COMPANY

No. 6595 No. 6595

THIRTY YEAR FIVE PER CENT COLLATERAL TRUST GOLD BOND.

AMERICAN TELEPHONE AND TELEGRAPH COMPANY, a corporation organized under the laws of the State of New York (hereinafter called the Telephone Company), for value received, hereby promises to pay to bearer, or, if this bond be registered, then to the registered holder hereof, on December 1, 1946, at the office or agency of the Telephone Company in the Borough of Manhattan, City of New York, State of New York, or, at the option of the holder, at the office or agency of the Telephone Company, in the City of Boston, Commonwealth of Massachusetts, the sum of

ONE THOUSAND DOLLARS

in gold coin of the United States of, or equivalent to, the present standard of weight and fineness, and to pay interest thereon from December 1, 1916, at the rate of five per cent per annum, such interest to be payable at either of the said offices or agencies of the Telephone Company, in like gold coin, semi-annually, on the first day of June and the first day of December in each year,

until the payment of said principal sum, but only upon presentation and surrender of the coupons therefor hereto attached, as they severally mature. This bond is one of a duly authorized issue of Thirty Year Five Per Cent Collateral Trust Gold Bonds of the Telephone Company, limited in its aggregate principal sum to eighty million dollars ($80,000,000), issued under and pursuant to, and all equally secured by, an indenture of trust dated December 1, 1916, duly executed by the Telephone Company to Old Colony Trust Company, a corporation organized under the laws of Massachusetts, as Trustee, to which indenture reference is hereby made for a description of the property pledged with said Trust Company, the nature and extent of the security, and the rights of the holders of said bonds and of the Trustee in respect of such security. In case of certain defaults specified in said indenture, the principal of all such bonds may be declared and may become due and payable in the manner and with the effect provided in said indenture. Unless registered as herein provided this bond shall pass by delivery. This bond may be registered as to principal in the owner's name at the office or agency of the Telephone Company in the Borough of Manhattan, City of New York, State of New York, or in Boston, Massachusetts, such registry being noted on the bond, after which no transfer shall be valid unless made at said office or agency and similarly noted on the bond; but the same may be discharged from registry by being transferred to bearer, and thereupon transferability by delivery shall be restored. Such registration, however, shall not affect the negotiability of the coupons for the interest hereon, and such coupons shall continue to be payable to bearer and transferable by delivery merely, and payment thereof shall fully discharge the Telephone Company in respect of the interest therein mentioned whether or not the bond be registered. In the manner prescribed in said indenture and upon payment of the charges therein provided, the holder of any coupon bond or bonds of the denomination of $1000, at his option may surrender for cancellation such bond or bonds with all unmatured coupons in exchange for a registered bond without coupons for the same aggregate principal sum. Any such registered bond, in like manner, and upon payment of the charges provided in said indenture, may in turn be exchanged for a coupon bond or coupon bonds for the same aggregate principal sum and bearing all unmatured coupons. On any interest payment date, this bond is subject to redemption at 105 per cent of the par value thereof and accrued interest, by operation of the sinking fund or at the option of the Telephone Company upon publication of notice of such redemption in the Borough of Manhattan, City of New York, and City of Boston, Massachusetts, as provided in said indenture, the first publication of said notice to be not less than sixty days prior to such redemption. Said indenture provides for an annual payment by the Telephone Company to the Trustee of a sum equal to one per cent of the aggregate principal sum of the bonds that have been

authenticated by the Trustee under said indenture, which shall be used in retiring bonds issued thereunder, at 105 per cent of their par value or less. No recourse shall be had for the payment of the principal of or the interest upon this bond, or for any claim based hereon, or otherwise in respect hereof or of said indenture, against any incorporator, stockholder, director, or officer, past, present, or future, of the Telephone Company or of any successor corporation, whether by virtue of any constitution, statute, or rule of law or by the enforcement of any assessment or penalty or otherwise, all such liability being, by the acceptance hereof and as part of the consideration of the issue hereof, expressly released, as provided in said indenture. This bond shall not be entitled to any security or benefit under said indenture, and shall not become valid or obligatory for any purpose, until it shall have been authenticated by the execution of the certificate, hereon endorsed by the Trustee under said indenture.

IN WITNESS WHEREOF, the Telephone Company has caused its corporate seal to be hereto affixed by its secretary or one of its assistant secretaries, and this bond to be signed in its name and on its behalf by its president or one of its vice-presidents, and by its treasurer or one of its assistant treasurers, and the annexed coupons to be authenticated by a fac-simile of the signature of the treasurer, all as of the first day of December, 1916.

AMERICAN TELEPHONE AND TELEGRAPH COMPANY.

By JAMES ROBB, *Vice-President.*

W. J. PRAT, *Assistant Treasurer.*

TRUSTEE'S CERTIFICATE

This is one of the coupon bonds described in the within mentioned indenture of trust.

OLD COLONY TRUST COMPANY.

Trustee.

By J. G. STRAND, *Vice-President.*

COUPON.

On the first day of DECEMBER, 1917 (unless the bond to which this coupon is annexed, shall have been called for previous redemption),

AMERICAN TELEPHONE AND TELEGRAPH COMPANY

will pay to the bearer at his option at its office or agency in the Borough of Manhattan, City of New York, or in Boston, Massachusetts,

TWENTY-FIVE DOLLARS ($25)

in gold coin of the United States, being six months' interest then due on its Thirty Year Five Per Cent Collateral Trust Gold Bond, number 6595.

G. D. MILNE, *Treas.*

Coupon No. 2.

FORM FOR REGISTERING BOND.

Notice.—No writing on this bond, except by an officer of the Company.

Date of Registry	In Whose Name Registered	Signature of Transfer Agent
.....	.....	.....
.....	.....	.....
.....	.....	.....

4. The granting clause, transferring the property to the trustee, and describing it in detail. In a mortgage bond, this clause is in the form of a mortgage upon real estate, in favor of the trustee. In a collateral trust bond, it is in the form of a pledge of collateral security to the trustee.

5. The duties and responsibility of the trustee are recited, including the statement that the property is granted only in trust and that the trustee shall certify to the validity of each bond issued.

6. The covenant of the corporation to pay principal and interest upon the bond as specified.

7. Provisions relating to the possession and maintenance of the property pledged, with the idea of preserving the lien value of the security. In the case of a mortgage bond, the obligor retains the complete control and possession of the mortgaged property, unless it is taken over by the trustee upon default of

principal or interest. In the collateral trust bond, the trustee retains the securities deposited, but, in the absence of default, usually remits the interest or dividends received thereon to the debtor corporation. In either case, the obligor assumes the duty of preserving the value of the property pledged as security pending final payment of the bond.

8. A statement of the nature and standing of subsidiary companies. This is included only when their earnings or properties form an essential part of the security behind the new bonds.

9. Procedure in case of default, including a definition of what constitutes default, the period of grace allowed, the authority and procedure under which the trustee must act, etc. Sometimes the trustee is given arbitrary power to foreclose and sell the property, but usually the consent of a certain proportion of the bondholders is required.

10. Procedure of the trustee in event of receivership.

11. The responsibilities, liabilities and compensation of the trustee, with the provision for his removal and the appointment of his successor.

12. Clause absolving the officers and directors of the corporation from personal liability, whether arising from the default of the company, or error or fraud on the part of the trustee.

13. A section defining the terms and phrases used thruout the indenture.

14. The signatures and seal of the corporation, by

its officers, and the signature and seal of the trustee.

If modifications of the original deed of trust are required, they may take the form of a supplementary indenture, requiring the consent of all parties concerned. These are required frequently in cases of receivership, reorganization, or changes in the legal status or property of the debtor company. Minor and less formal changes may be made by supplementary agreement of a less formal nature. Sometimes clauses are inserted in the deed of trust, providing the manner in which such changes shall be made, or a substitution of security effected.

5. *Collateral trust indentures.*—In addition to these ordinary provisions, the collateral deed of trust contains a number of safeguards, designed to preserve the value of the collateral, especially when the latter consists of stock. These relate usually to the following:

1. Any additional stock issued by subsidiaries to be deposited with the trustee in the same proportion as present issues.

2. Dividends not to be declared which will decrease the surplus below the amount existing at the time the loan was made.

3. All necessary repairs, renewals and replacements to be made by subsidiary companies out of their own earnings, and before any dividends are declared.

4. Limitations upon the right to lease out the property of the companies whose securities are held as collateral.

5. Restrictions upon the sale of the property of the borrower, or of the companies whose securities are held as collateral, unless the proceeds are used to retire a part of the bonds or deposited with the trustee for the purchase, with the consent of the bondholders, of additional property at least as valuable as the property sold.

6. Limitations upon the power to incur debt, except for the purpose of improving or extending the property of the company in order to increase its productive capacity.

In the case of bond collateral, the principal safeguard consists in a prohibition against the issue of other bonds of prior or equal rank which would tend to weaken the lien of the existing bonds, or the issue of junior obligations for unproductive purposes. To insure against this, the borrowing company, if it owns the stock of the subsidiary company, whose bonds are deposited as collateral, may be required also to deposit with the trustee a controlling interest in this stock. By his controlling vote, the trustee can then prevent any further borrowing that would weaken the lien of the outstanding bonds or the earning power of the company. Another object of this precaution is to prevent the parent company from exploiting its subsidiaries to secure funds for some temporary expenditure that might jeopardize the solvency of the company and the security of the bond holders.

6. *Substitution of collateral.*—Unlike mortgage bonds, the trust deed, in the case of collateral trust

bonds, usually does not provide for the substitution of collateral. The reason for this is found in the nature of the security. Real estate is more substantial and its value to the borrowing company more easily determined than in the case of stocks and bonds. Accordingly, substitution is accomplished more easily and with less risk to the bondholders, in the case of real estate.

Some collateral trust obligations, however, are drawn subject to the substitution of collateral to a limited extent. In such case, the kinds of collateral which may be substituted are usually stated in a general way, and the substitution is made on the basis of the market values of the securities. The judgment of the trustee may govern the transaction, or, if the company and the trustee cannot agree, a committe of appraisers may be provided to evaluate the securities offered in exchange. The deed of trust under the Oregon Short Line fours, of 1904, provides that the trustee may appoint one appraiser, the railroad company another, and these two a third, and that the judgment of the majority of these appraisers shall be final as to the value of the security offered for substitution.

7. *Purpose of collateral trust bonds.*—Companies whose only property consists of the stocks and bonds of other companies are practically limited to the collateral trust bond. Such companies are strictly holding companies and are illustrated best by the large industrial combinations which have become so

powerful within the past twenty years. In such cases, it is usual for the trust deed to convey to the trustee all the stocks and bonds of subsidiaries owned by the holding company. The advances made by the holding company to its subsidiaries, out of the proceeds of the bond sale, are evidenced by additional securities given by the subsidiary to the holding company and turned over by the latter to the trustee. If prior lien obligations of subsidiaries are outstanding, provision is often made for refunding them by a bond reserve, so that the collateral trust bonds will eventually be secured by first liens upon all the properties of the subsidiary companies.

As a rule, industrial companies cannot borrow much upon first mortgage bonds, because their earnings fluctuate widely and their properties are of specialized and uncertain value. Consequently, their collateral trust obligations are secured largely by the stocks of subsidiaries and depend mainly upon their surplus earnings for repayment. It is plain, however, that the existence of any prior lien against the property of subsidiaries, or any discretion retained by the debtor company to create such additional prior liens, or liens equal in rank to the new issue, would jeopardize the security of the collateral trust bonds. This explains why all the securities usually are required to be deposited with the trustee, leaving him in position not only to prevent the creation of future prior liens, and the dissipation of the company's assets, but also to control the company for the benefit

of bondholders in the event of default, without the necessity of foreclosing on a mortgage to get possession.

The collateral trust bond is commonly employed to finance construction by subsidiary companies. The credit of both the subsidiary and the controlling company are thrown together for the purpose of borrowing to the best advantage. In the same manner, the credit of the subsidiary and of the holding company may be merged to secure capital for an extension of the direct property of the latter.

Collateral trust bonds are also employed by corporations to acquire the stock of other companies. This purchased stock, when pledged as collateral under the bonds, furnishes the means for its own purchase, without drawing extensively upon the credit of the purchasing company. Of course, if the income from the securities purchased is not ample to meet the interest upon the collateral trust bonds which they secure, then the general credit of the purchasing corporation may become the chief reliance of the bondholder. Usually, however, the income from the stock purchased is greater than the interest upon the bonds, thus actually increasing the surplus and the credit of the debtor controlling corporation by enhancing its annual profits. This is a case in which the credit of a corporation becomes better by borrowing, and illustrates the manner in which many of our largest combinations, by means of holding companies, have been

able to acquire property, income and power out of all proportion to their original capital investment.

8. *Security of collateral trust bonds.*—To what extent does the security of the collateral trust bond depend upon the collateral, and to what extent upon the direct promise of the borrowing company?

Clearly, when a corporation is strictly a holding company, the value of the collateral is practically the sole security of the bond, unless the borrowing company, having pledged only a part of its holdings with the trustee, has other unencumbered securities.

When the value depends upon collateral consisting of the stocks of other companies, collateral trust bonds are naturally highly speculative and will fluctuate widely in value with the earnings of the subsidiary companies, since the collateral trust bondholders depend upon the dividends of these subsidiaries for their interest. The fluctuation, of course, is not as wide as that of the stocks pledged as collateral, for the reason that bonds mature on a definite date for a certain amount, and therefore cannot rise very far above par. But they may sink to any depth below par, or may become entirely valueless if the subsidiary companies become bankrupt. This explains why collateral trust bonds are usually secured by stocks and bonds of several companies and are not confined to the hazard of only one or two subsidiaries.

Collateral trust bonds are best issued when the credit of the borrowing corporation itself is ample to

meet the interest charges irrespective of any income from the collateral deposited.

REVIEW

What is a collateral trust bond, and by what classes of corporations are they issued?

Describe a guaranteed bond, and the forms which the guarantee may assume.

What is the nature of the deed of trust used in the issue of collateral trust bonds?

What are the usual purposes in issuing bonds of this character?

What is the advantage of mixed securities as collateral?

CHAPTER IX

BONDS SECURED BY LEASES

1. *Leases as collateral.*—A lease is a contract by which one party, known as the lessor, temporarily transfers the possession of property to another party, known as the lessee, in return for a certain charge, known as a rental.

As a rule, leases serve as collateral for bonds only in the purchase of railway equipment, and especially when a closed first mortgage or the after-acquired property clause interferes with making a new direct loan against the equipment to finance its purchase. These obligations are known as car or equipment trust bonds, or car-trust certificates.

The lease may be used as security in three different ways. The first is for a syndicate, usually headed by some prominent banker, to purchase the equipment and lease it to a railway company for a certain amount down and certain deferred rental payments, following the complete payment of which the equipment is transferred to the railway for one dollar and becomes its own property. The deferred payments are evidenced by equipment notes, which are interest bearing obligations of the railway, usually in denominations of one thousand dollars each and matur-

ing in series or instalments upon the dates on which the deferred rental payments fall due.

The syndicate, having now purchased the equipment and leased it to the railway, assigns the lease to a trustee, usually a trust company, under a trust agreement which pledges the lease as security for the equipment notes. These notes are known as car-trust certificates. They are issued and certified thru the trustee much in the same manner as bonds, and the trustee is authorized, in case the rentals and other requirements of the lease are not maintained by the railway company, to take back the equipment and sell it for the benefit of the holders of the trust certificates.

A second method of utilizing a lease as security for bonds issued to purchase equipment is for a subsidiary company, whose stock is held by the railway, to sell its equipment bonds. The subsidiary company, having been formed solely for this purpose, buys the equipment, leases it to the railway, and sells its own bonds in order to secure funds to pay for the cars. Its bonds are usually guaranteed by the railway company and are secured by the deposit of the lease with a trustee, as security for the bondholders.

A third use of the lease as security is found only in the case of long-term leases, which cover rights-of-way and other permanent property, and are not confined to equipment. If the lessee company earns a substantial profit on such lease over and above the rental charges, the leasehold may become very valuable, and in such case may itself become good security

for bonds. A good example of this form is found in the bonds of the Interborough Company of New York City, which are secured mainly by a 999 year lease, covering street, elevated and subway lines in New York. It should be noted in this case that the lessee is the borrower, the bonds being secured by the surplus earnings of the leased property, and not by the equipment or property itself.

2. *Security of equipment trust bonds.*—Equipment trust bonds such as the car-trust certificates above mentioned, are very secure and enjoy an increasingly broad market. This is because the equipment covered by the lease is practically indispensable to the railway, and can be taken from it instantly in the event of default.

Unlike many other forms of property, railway properties are of such a specialized nature that their value ceases almost entirely when the road ceases to operate. A station or a mile of track may be worth fifty thousand dollars to the railroad as an operating concern, but may not be worth five thousand dollars to any one else for another purpose. Railways, therefore, must continue to operate regardless of their financial condition, and of course this requires equipment, without which operation would be impossible. Since the leased equipment is not the property of the railway, a receiver of the road cannot control it, except under the terms of the lease. Car-trust certificates and the interest thereon, therefore, will be paid, even before receivers' certificates, in order that the

equipment of the road may be retained in use pending reorganization. If not paid, the trustees may immediately withdraw the equipment under the lease and sell it to other roads. Defaults upon equipment trust bonds are practically unknown.

Equipment bonds derive additional security from the fact that the relative value of the collateral increases with time, as the bonds are retired. This is because the life of the bond is shorter than the life of equipment which secures it, with the result that the margin of security constantly increases as the bonds are paid. Furthermore, the equipment must be maintained in good condition, not only as a necessity of operation, but because the trustee is empowered to cancel the lease and take back the rolling stock if this is not done. These bonds never run longer than ten years, one-tenth of them being paid off each year, but the equipment has a much longer life and remains the property of the bondholders, under the trustee, until the last bond has been paid off.

3. *Grand Trunk short-term notes.*—Some surprise was created in American and English financial circles in July, 1913, when the Grand Trunk Railway of Canada issued in London £1,500,000 five-year, 5 per cent secured notes, dated October 1, 1913, and due October 1, 1918. The notes were in denominations of £200 and £100, registered as to principal only. The company reserved the right to redeem the notes at 101, either as a whole or in amounts of not less than £200,000, by drawings on any interest date

upon sixty days' notice. In the event of any notes being reduced before the date of maturity, the trustees would release a proportionate part of the debenture stock deposited with them as security. The notes were secured by the deposit with the trustees of £2,000,000 Grand Trunk perpetual 4 per cent consolidated debenture stock.

The proceeds of the notes were to be applied in part payment for additional rolling stock (75 engines and 8,000 freight cars), the contract price of which exceeded £2,000,000. It looked, therefore, like an issue of equipment notes, but Canadian financial authorities were not inclined to class them as such, since the terms of payment and the periods are somewhat different from the standard equipment trust bond or note described in previous pages.

4. *Terms of the lease.*—Space will not permit reproducing the Text of a corporate lease. The following, however, are the more usual provisions:

1. A description of the leased property. In this connection, it should be noted that the inventory may change from time to time as the condition and character of the property change. Annual inventories may be filed with the trustee or lessor.

2. Length of the lease. In case of equipment rarely more than ten years. In case of permanent properties, such as rights-of-way, etc., usually 99 years, but sometimes as long as 999 years. Sometimes shorter leases are subject to renewal on certain stated terms.

3. Payments under the lease. These usually provide that the lessee, in addition to the rental, should pay all taxes, insurance, interest and maintenance charges. The rentals may be a fixed amount or based upon a sliding scale, which permits the lessor to share in the profits arising from the use of the leased property.

In equipment leases, however, it is customary to provide for certain definite payments. The original cash payment should be sufficient to cover the expenses and profits of the syndicate or lessor company, and subsequent deferred payments should be gauged to cover the actual cost of the equipment. The subsequent payments are equal in amount to the equipment trust bonds which have been sold to pay the manufacturers of the equipment. Many varying practices govern payments by lessees under leases. These stated here are the more usual ones.

5. *Maintenance of the leased property.*—If proper maintenance of the property is not stipulated the lessee might abuse the property for the purpose of making high profits from its use, regardless of the interest of the lessor. This is particularly true in the leasing of permanent properties, such as rights-of-way, terminals, etc., the upkeep of which the lessee is likely to neglect as the expiration of the lease approaches, unless a renewal is anticipated.

In the case of equipment bonds, it is merely necessary to provide that all properties destroyed or injured shall be replaced by the lessee, and that the

equipment shall be kept in first-class condition. Since equipment syndicates or subsidiary companies are usually friendly interests controlled by the lessee railway, difficulty in this line rarely occurs.

In the case of long-term leases of permanent properties, however, such as that of the Interborough Company previously mentioned, very exhaustive provisions are necessary to insure that the lessee will preserve and maintain the property in thoro repair and working order, at full efficiency, and return it to the lessor in at least as good condition as when the lease was made originally, by replacing worn out, damaged or lost equipment, etc., and complying during the leasehold with all requirements of law regarding the construction, maintenance and operation of such property.

6. *Provisions for the sale or substitution of property covered by the lease.*—In long-term leases of permanent properties, sale or substitution of property covered must be allowed. Operating conditions, rights-of-way and forms of equipment change with time, and a way must be left open for keeping the properties up to date. The lease usually provides that the proceeds of property sold shall go to the trustee, to the lessor, or back into the property itself.

7. *Leasing of business properties.*—Entirely aside from its utility in purchasing equipment, the lease has many advantages as a method of acquiring permanent producing properties. When the lessee corporation is powerful, its guarantee of a steady

rental, sufficient to pay good dividends to the stockholders of the lessor company, is very attractive to the latter. The payment of such dividends at an agreed rate is frequently the measure of the rental charged. Such an arrangement, accompanied by adequate provisions for the maintenance of the property in good condition by the lessee corporation, stabilizes the security values of the lessor, without any active effort on its part. In addition to the earning power of their property, the stockholders of the lessor now have the contract of the lessee corporation to guarantee dividends.

The advantage to the lessee is equally evident. It secures immediate possession of a fully equipped, organized and running business property without awaiting the construction of a plant or the tedious process of building up a new business. There is the additional advantage that the negotiations for the lease are simple and require but little capital. The lease merely needs the ratification of the boards of directors of both companies. The directors in turn usually secure the consent of the stockholders without difficulty, especially if the lessor company has had a checkered career, which the stockholders are glad henceforth to escape.

The lessee corporation makes a small payment down, assumes the payment of all future maintenance and fixed charges upon the property, and promises certain periodic dividend payments to the stockholders of the lessor. These payments may begin at a

low level and gradually increase to a maximum dividend rate, which is often six per cent. The lessee expects to earn enough from the operation of the leased property to make all these future payments and in addition a margin of profit for itself. It is expected that the lease will pay for itself and therefore very little financing is required.

If the property were to be acquired without a lease, it would be done ordinarily by purchasing the controlling interest, or perhaps the entire capital stock, of the acquired company. This requires considerable financing. Even if this money is raised by depositing the stock as security for an issue of collateral trust bonds, the bonds themselves must be sold, whereas, in the case of a lease, the cash to be raised immediately consists only of the hand payment at the time the lease is signed.

8. *Financing improvements on leased property.*— When plant assets are conveyed, corporate leases usually provide that portions of the property which become obsolete, or are no longer useful, may be sold by the lessee and the proceeds applied to improvements upon the property. It is obviously to the interests of both parties that this should be done.

With a short-term lease, naturally the lessee hesitates to make improvements upon the property, knowing that it may revert to the lessor at the expiration of the lease without any compensation for the improvement made. If the lease is renewed, it may be that the lessor, because of the improved value of the

property, will increase the rental, actually penalizing the lessee for a gratis improvement upon the property of the lessor.

Sometimes the lessee finds himself unable to finance necessary improvements without pledging the property itself or utilizing the credit of the lessor. Of course, this cannot be done unless provided in the lease or consented to by the lessor. For instance, if the lessee of a street railway should find it necessary to electrify the line, elevate the track, or instal a subway system upon a franchise controlled by the lessor, all of which improvements might be necessary to uphold the value and income of the properties, the lessee corporation undoubtedly would be justified in expecting the lessor to lend his assistance in raising new capital.

This may be done in various ways. The lessor may loan certain securities to the lessee to be deposited behind an issue of collateral trust bonds, which are the obligations of the lessee; or the lessor itself may borrow upon such collateral trust bonds, advancing to the lessee the funds thereby secured to be expended upon the property. Mortgage bonds may be issued against the property, with the consent of both parties, either as the obligation of the lessee or of the lessor, provided the property is good security for a mortgage. Sometimes the lease gives the lessee the option of requiring the lessor to issue additional stocks or bonds for the purpose of improving the property, as in the case of the Boston Elevated Railroad Company. Here again

arbitrators may be necessary to determine when such advances shall be made under the terms of the lease.

In any event, if the funds, credit or property of the lessor are used to finance improvements which may immediately enhance the earnings of the lessee, the funds so advanced are never used for anything except permanent additions and improvements. If there is an open mortgage or a bond reserve, secured by a mortgage upon the property, at the time the lease is made, it is possible, of course for the lessee, under carefully drawn restrictions, to acquire the right to sell these unissued bonds without further recourse to the lessor, subject only to such restrictions as the mortgage may impose.

REVIEW

When are leases used as collateral for bond issues?

Describe the equipment trust bond.

State in general terms the usual provisions of corporate or equipment leases.

State the advantages of the lease as a method of acquiring permanent producing properties.

What methods may be employed in financing improvements on leased property?

CHAPTER X

MISCELLANEOUS BONDS AND PREFERRED STOCKS

1. *Debenture bonds.*—We have seen that bonds are essentially of three classes: mortgage bonds, secured by real estate; collateral trust bonds, secured by personal property; and debenture bonds, not secured by the pledge of any specific asset. Redeemable, convertible, participating, or income bonds are only titles indicating some important characteristic in the payment of principal or interest, which may apply equally well to mortgage, collateral trust, or debenture bonds. Mortgage and collateral trust bonds have been briefly described. It remains for us to discuss debentures as a class.

Debentures are plain, unsupported promises to pay. Excepting long-maturity notes and the formality with which they are drawn, there is no difference between them and "unsecured" corporation notes. In the event of default, the only remedy of the debenture bondholder, is to enter suit against the corporation, as no part of its property has been segregated for his protection.

Most government bonds are debentures, since payment of principal and interest depends entirely upon the taxing power of the government. In England, most railway bonds are debentures. The English

investor feels that, after all, the earning power of the corporation is his only ultimate protection. Theoretically, he is right, for if the operation of a railway is interrupted by foreclosure under liens covering portions of the property, its earning power will practically cease, and the real protection of the lien be defeated. In practice, it makes little or no difference to the bondholders whether its bonds are all mortgage bonds or all debentures, provided all those outstanding are upon the same basis and come in before the current liabilities.

The American investor likes specific security. The early hazardous financing of American railways seemed to demand the mortgage bond, and it is still the predominant type. The collateral trust bond carries out the same principle, but it is better adapted to complicated holding company situations, such as have developed from the rapid combination of American railways and industrial corporations, with their small divisional mortgage bonds still outstanding.

The debenture bond in the United States has been issued principally in reorganizations for the purpose of reducing the amount of mortgage liens, and thus strengthening the remaining mortgage bonds. The New England railways have issued quite a few debenture bonds, typified by those of the Boston and Maine and the New York, New Haven and Hartford Railroads. Outside New England, not many of these bonds are found in the United States, either among railways or large industrial corporations.

In the absence of specific provisions to the contrary, debenture bondholders rank with other general creditors in the payment of interest and the distribution of assets. However, it is customary, for the debentures, even tho not secured by lien, to have priority over other general creditors. When debentures are issued to keep down the mortgage debt, in reorganization or otherwise, it is usually provided that outstanding debentures shall share in the security of any new mortgage which may be placed later upon the company's property. Otherwise, additional mortgage bonds might be issued ahead of the debentures at any time. Debenture bondholders should insist that mortgage indebtedness be strictly limited. Debentures do not carry the right of foreclosure on default, and therefore possess neither the security nor the strong contingent control held by the junior mortgage bonds of the same company.

In order to make debenture bonds look attractive, it is customary to make them convertible into stock, either before or after some given date, and at some fixed price above par. This adds a speculative element which makes some issues of convertibles highly marketable. Without the conversion privilege, the debenture bondholder is likely to feel that he loses whichever way the affairs of the company go. If the company goes under receivership or bankruptcy, he stands behind all the mortgage creditors. If the company is extremely profitable, the stockholder may get high dividends, but the debenture bondholder's in-

come and the value of his bonds are limited by a fixed interest. With the conversion privilege, debentures share in the prosperity of the company if its stock goes to high prices.

Since debentures depend for their value upon the earnings of the company, another protection often extended to them is the guarantee that the proceeds of the issue will be invested in productive assets in such manner as to increase earning power. This restraint upon management of income is also applied to preferred stocks, as we shall see, and it constitutes an element of real strength.

2. *Convertible bonds.*—A convertible bond is one which may be exchanged by its owner for capital stock, either common or preferred as the case may be. The exchange privilege may be limited within certain dates stated in the bond, or it may extend over the full term of the issue.

The conversion ratio, or price, is always stated in the bond, or trustee's agreement, as, for instance, ten shares of stock for one bond, par for par. Naturally, if the stock rises to a higher market value than the bonds, the bond owners will take advantage of the conversion privilege to make a speculative profit on their holdings. Once the price of the stock exceeds the normal market value of the bonds, the prices of the two will move upward together, with the bonds a trifle lower than the stock. However, if the price of the stock falls below the market value of the bonds, the latter will not continue to decline with the stock.

Since earnings constitute the greatest single factor in determining the values of both stock and bonds, the prices of debentures will naturally be depressed by any influence which causes the stock to decline, but the downward movement of the bond will be less marked because it supersedes the lien of the stock and matures on a given date at par. The stabilizing influence of definite maturity upon bond prices will be explained in the next chapter.

Altho debenture bonds do not accord with the American custom, some large issues of convertibles, such as the five per cent convertible gold debentures of the Atchison, Topeka and Santa Fe Railroad, have found growing favor because of the combined investment and speculative feature found in the conversion privilege.

3. *Participating bonds.*—Another form of speculative privilege attached to bonds, by which the bondholder may share with capital stock in the surplus profits of the company, is known as the participation privilege. In addition to their stated interest, participating bonds receive a certain proportion of the surplus earnings of the company after the stockholders have received a stated dividend. It may be provided, for instance, that after the bonds have received five per cent, stockholders shall next receive six per cent, and the additional earnings available for distribution be divided equally between them. Usually there is a maximum participation, above which all surplus profits go to the stockholders. The vari-

ous plans of participation are too numerous to describe, but they are all based upon the same principle and purpose.

The participation privilege is used to make weak bonds more palatable to investors. It is a provision found mostly in industrial issues, which appeal to the semi-speculative classes. They desire the safety of a bond, but are willing to take reasonable risks in exchange for the opportunity of participating in the surplus profits. The owner of the participating bond, unlike that of the convertible, does not jump from one extreme to the other, from creditor to stockholder, but retains his preferred position as a bondholder. Security and other conditions being equal, speculative profits are more limited upon participating bonds than upon convertibles, because participating bonds are tied closely to par values and depend for speculative profits mainly upon participation, instead of market increase. Participation is rarely great, but upon the same earnings the stock, followed by convertible bonds, may soar to high prices.

Either class injects an element of great uncertainty into the affairs of the corporation. This is particularly so with the convertible bond, as the exercise of the conversion privilege makes possible radical and rapid changes in the capitalization of the company. Both of these privileges also tend to depress capital stock values, since they may eat into profits which would otherwise go to stockholders in dividends.

4. *Redeemable bonds.*—A redeemable bond is one

which may be paid by the corporation before maturity. If the date of payment is optional with the corporation, it is sometimes called an optional bond, or a callable bond. Since the fluctuation in bond prices is not very broad or rapid, speculation in securities is confined mainly to the stock market. The bond market is therefore less active and it is sustained largely by the demands of permanent investors, who desire the greater safety and more steady income of bonds, rather than the risks and uncertain income of stocks. Any element in the bond, therefore, which lends uncertainty to the date of payment, with consequent inconvenience and perhaps loss of interest to the investor while changing investments, detracts from its market value.

For this reason redeemable bonds usually carry with the redemption privilege a bonus or premium, which overcomes the investor's objection and adds a speculative value to the bond. It is often provided, for instance, that bonds may be redeemed at 105 on any interest bearing date, after thirty days' notice. Now, if this bond were to run until maturity, the owner would receive only par value for it. The extra five per cent represents a bonus paid to him for the redemption privilege.

The right to redeem is often quite important to the corporation, and is growing in favor. There is no reason why this feature should not exist in all bonds, provided the redemption price and other conditions are sufficiently liberal not to interfere with the mar-

keting of the bond. As a matter of fact, the possibility of a high redemption premium may even improve marketability, and thus return to the company in advance, in the original selling price of the bonds, a part of the redemption premium which it has agreed to pay. It is only thru redemption that the debtor is able to take advantage of favorable refunding conditions which arise before maturity. Enlargement in the business or assets of the company, improvement in its credit or in the market conditions, or the necessity of increasing its indebtedness to finance expansions may render a refunding desirable.

If a bond issue has forty years yet to run, and, owing to favorable conditions, it may be refunded at a saving of one per cent per year in the interest rate, it is clearly in the interest of the company to pay the five per cent redemption premium and refund the bonds in order to save the forty per cent in interest during the life of the issue.

5. *Income bonds.*—The income bond is not frequently used. Its name is derived from the fact that it receives no fixed interest, but merely participates in net earnings. Interest is payable only when it has been earned and the judgment of the directors is final. The bonds may have any class of security, as to the principal, and mature like other bonds upon certain fixed dates. The principal is ordinarily secured by a junior mortgage, or collateral deposited with a trustee, and the interest is payable if earned up to a certain fixed rate, usually six per cent.

The income bond is issued, as a rule, only in reorganizations, in order to reduce the fixed interest charges and, at the same time, to give to the former bondholder, whose preference is scaled, an obligation which comes ahead of all capital stock, as to both principal and interest. It combines the form and security of principal of a bond with the dividend features of preferred stock. As to earnings, the income bondholder is practically the owner of first preferred stock. Such bonds share the income risk of the stockholder without exercising the voting control which usually accrues to stock. Some such issues have been debentures without specific security, and no better in any particular than preferred stock. A few issues have presented the astonishing feature of possessing neither cumulative dividend provisions nor any measure of voting control in the absence of dividends.

Probably the most notable issue of income bonds was that of the Central of Georgia Railway Company. This case well illustrates one of the chief difficulties of income bonds: namely, that it may be a matter of dispute whether or not the interest upon them has actually been earned. This decision rests with the directors of the company, unless the bondholders can show fraud or manipulation, as they finally did succeed in showing in the Central of Georgia case after many years of expensive litigation. In the maze of accounting procedure it is quite easy to

hide the profits of large corporations, and this is particularly so where subsidiaries are operated.

It should be noted that income bonds are almost never justified, except in reorganization emergency. When secured by a junior lien, they may embarrass the corporation in its future borrowing, whereas preferred stock does not do so, and in other ways it is preferable to the income bond.

6. *Nature of preferred stock.*—When there is more than one class of stock, all those classes which possess special privileges are called preferred, and all the rest are known as common stock. The preference may consist of any one, or more, of three kinds:

1. In the distribution of principal upon liquidation
2. In dividends
3. In voting power.

When one class of stock retains the voting power and another class has preference as to principal or dividends, the latter is the preferred because voting privileges are second in importance to security. It is usually considered that the common stockholders, who take the marginal risks of the business, should possess the voting control. It is their only protection.

A stock which is preferred as to principal receives its full par value when the company is liquidated, before anything is paid upon the principal of common stock. Preference as to dividends indicates that the

preferred must receive a stated dividend before anything may be paid out of profits to common stockholders. Voting control, whether it relates to preferred or common, indicates the power to vote at the election of directors, or upon certain specific questions of policy which may be brought before the stockholders for decision.

It should be noted that preference as to principal does not make the stock a liability of the company. Such preference becomes operative only upon liquidation and is even then secondary to the claims of all creditors. Preferred dividends are not fixed charges of the company, but are payable out of earnings, on vote of the directors, in the same manner as common dividends. There may be several classes of preferred stock, known as first, second, and third preferred, etc., each possessing some stated degree of preference.

7. *Purposes of preferred stock.*—The purposes of issuing preferred stock may be summarized as follows:

(a) To enable common stockholders to trade or control upon a thinner equity.
(b) To scale down junior lien bonds and reduce fixed charges in reorganization.
(c) To pay for properties or securities purchased in consolidating.
(d) To secure capital when the sale of bonds or common stock is not practicable or advisable.

Many investors who are perfectly willing to buy

preferred shares surrounded with adequate safeguards and bearing liberal cumulative dividends will not purchase common stock. Preferred stock appeals to a class midway between bond investors and those who desire the speculative risks and profits of common stock. Preferred stock is inferior to bonds, as to both principal and interest, and therefore it demands a higher return. It usually bears cumulative dividends of from six to eight per cent, while bonds receive cumulative interest of from four to six per cent. Bonds possess a strong contingent control in the form of the right to foreclose upon default of either principal or interest. Preferred stock has no such contingent right, but insists instead upon some voting powers or restraints upon the management.

Preferred stock is passing out of favor with railways, for the reason that they have sufficient bonding power to absorb a large portion of their earnings and cannot afford to pay the higher interest rate demanded upon preferred stock. Industrial corporations, on the contrary, usually do not possess sufficiently stable assets or earnings to serve as a basis for bonds in any large amount, and therefore they are compelled to rely mainly upon the sale of preferred stock.

8. *Equity and voting power of preferred stock.*—It is evident that the issue of preferred narrows the equity and increases the profits of common stockholders in the same manner as the issue of bonds, but to a lesser extent. With the common in control, the

PREFERRED STOCK CERTIFICATE, FULL-PAID

Certificate No. 15
For 10 shares.
Dated December 2, 1912.
Issued to
W. H. Walker,
323 Fourth Ave.,
Pittsburgh, Pa.

Issued against surrendered Certificate No..... (Original issue)

Received the above certificate this 2nd day of December, 1912.
W. H. Walker

168

This Certificate No. 15, cancelled.....19
Certificates issued in its stead as follows:
No..... for .....Share
No..... " ..... "
No..... " ..... "

No. 15 10 Shares

Incorporated under the Laws of The State of New Jersey

THE DUQUESNE IMPROVEMENT COMPANY

Capital Stock.....$150,000
Common Stock.....$100,000
Preferred Stock.....$50,000

Full-paid and Non-assessable

THIS IS TO CERTIFY that W. H. Walker is the owner of Ten Shares of the Preferred Stock of The Duquesne Improvement Company, transferable only on the books of the Company by the said owner, in person or by duly authorized attorney, upon surrender of this Certificate properly endorsed.

The preferred stock represented by this certificate is entitled to annual dividend of Six (6%) per cent payable out of the net profits of the Company before any dividend is paid upon the common stock. Should the net profits in any year be insufficient to pay said preferred dividend, either in whole or in part, any unpaid portion thereof shall become a charge against the net profits of the Company, and shall be paid in full out of said net profits before any dividends are paid upon the common stock.

Said preferred stock is subject to redemption at the option of the Company at any time after Ten (10) Years from the first day of April, 1913, upon payment of One Hundred and Five ($105) Dollars per share and any accumulated dividends.

Said preferred stock is not entitled to vote at stockholders' meetings of the Company, nor to participate in profits beyond its fixed, preferential, cumulative, annual dividend of Six Per Cent.

{CORPORATE SEAL}

Witness the Seal of the Company and the signatures of its duly authorized officers this second day of December, 1912.

R. S. JONES,
Treasurer.

J. B. SMITH,
President.

Shares, $100 each

sale of preferred shares is equivalent to borrowing, as far as the common stockholders are concerned, except that they pay a higher rate of interest upon preferred than upon bonds, and do not subject the company to the foreclosure rights which bondholders would possess.

It is evident that the preferred stockholder benefits likewise from the sale of bonds which bear a lower rate of interest than the preferred is receiving, because the surplus earnings thereby accruing to the corporation increase the margin of safety for the preferred stock. But borrowing on bonds, which bear a rate as high as, or higher than, the preferred is less advantageous to existing shares than the sale of new preferred stock, unless the bonds are sold at a premium. This is true because such bonds naturally increase the risks of preferred shares, without either increasing the earnings to the company or the margin of safety to existing preferred any more rapidly than would an additional issue of preferred stock.

When a corporation has two or three classes of stock differing only in voting powers, the only preference consists in the voting control thus granted. Sometimes such stock is termed "voting" and "non-voting" common stock. Practically the only reason for issuing a stock of such limited preference is to retain the division of authority in a partnership which is being incorporated. It may be desirable to retain the management in the hands of the senior partner, all partners, however, retaining similar financial interests.

This may be done thru the issue of voting and non-voting stock.

When preferred is in the minority, and its vote would ordinarily be powerless against the control of common, it is customary to provide that certain policies which are vital to the interests of preferred stockholders shall not be adopted without their consent. Such matters as increasing the bonded debt, issuing additional preferred stock, etc., must often receive the assent of a certain percentage of the outstanding preferred to become effective.

9. *Preferred stock in consolidations.*—The large industrial combines formed during the past twenty years consist mainly of holding companies of limited bonding power. The holding companies, as a rule, paid the owners of the securities which they purchased, in bonds and preferred stocks of the combine, with a bonus of common as an inducement. Bonds and preferred stock were issued to the full demonstrated value of the properties acquired, the common stock representing values supposed to reside in the good-will and in the economies of combination. The common stock was thus made to depend for its dividends upon the realization of these anticipated economies. Plant owners naturally were not willing to accept such common stock for their properties, but were willing to take bonds and preferred stock.

In many cases, the individual plants had not been profitable, and the owners feared the competition of

the new combine. They were not inclined to be over-particular as to the kind of preferred stock which they received. As a result, while the original preferred issues of most of the large industrial combines are preferred as to principal and cumulative dividends, they carry but little contingent control and impose very few restrictions upon the management.

10. *Issue of preferred to obtain new capital.*— When preferred stock is issued to obtain new capital in the market, and is subjected to the cold scrutiny of outside investors, it becomes necessary to surround it with various forms of contingent control and special forms of protection, of which the following are the most usual:

1. Preference as to principal and cumulative dividends
2. No new preferred stock to be issued, except upon the vote of a large majority of the existing preferred
3. Bonded debt not to be increased without the consent of a liberal majority of the preferred
4. Preferred to participate in surplus profits
5. Preferred to have general voting power, or else power to elect a certain number of directors
6. Preferred to have voting power or voting control in the event dividends are not paid when due

7. No dividends to be paid upon common stock until a certain surplus has been created, or a special reserve fund set aside for retiring portions of the preferred stock
8. The right of conversion into common stock upon liberal terms.

Of course, not all of these restrictions are to be found in any one issue, but usually several of them will be included in preferred that has been issued to obtain new capital.

Cumulative dividends require that if the stated dividend is not paid each year, it accumulates in favor of the preferred stockholder and must be paid up in full out of earnings before any dividend is paid to common. Thus, if a preferred stock bearing seven per cent cumulative dividend had received no dividends for two years, it would have to be paid 21 per cent accumulated dividends the third year before common stockholders could expect anything.

11. *Cumulative preferred stock in Canada.*—The heavy capitalization of a large number of corporations, the issue of substantial blocks of cumulative preferred stock, and the decline of their profits on account of depressed general conditions have proved an unhappy combination of circumstances for the cumulative preferred dividend in Canada. During the period following the outbreak of war in 1914, and also prior to that date, a large number of corporations were compelled to pass dividends on that type of stock. The

unpaid dividends continued to accumulate rapidly.

Some companies were able to pay their arrears by securing large war orders, but without the help of this special circumstance the shareholders would probably have had to wait still longer for their dividends.

The record of the cumulative preferred dividend in Canada has been such as to impress upon the shareholder that this form of stock is frequently erratic in its dividend action, and that when buying, too much value should not be attached to the cumulative feature.

REVIEW

What are the chief characteristics of debenture bonds?

Explain the conversion privilege and discuss its value as applied to debenture bonds.

What is a convertible bond? A participating bond? A redeemable bond?

When are income bonds issued and what is their nature?

What gives the name to preferred stock? What are the characteristics of such issues and what purposes do they serve?

Explain the rôle that preferred stock has played in consolidations.

CHAPTER XI

AMORTIZATION OF BONDS

1. *Necessity for the amortization of bonds.*—It is desirable, if the terms are advantageous, for corporations to borrow upon long-term bonds. When corporate notes or other short-term obligations mature, they are expected to be paid. When bonds mature, the debt is not usually retired, but is refunded by a new issue of bonds. Naturally these refunding operations are attended with some expense, inconvenience and uncertainty. From this, at first thought, it might seem logical that corporate bonds, when possible, should be made perpetual; that is, without any stated term or date of maturity.

The so called British Consols, originally issued by the British government to refund various maturing war bonds, are perpetual. The government, by purchasing the bonds in the open market, may retire the debt, but there is no fixed date upon which the holders of the consols are entitled to demand payment. Many British railway debenture loans are also perpetual. There are a few instances of perpetual loans in the United States, as, for example, the $20,000,000 issue of the Public Service Corporation of New Jersey's perpetual interest-bearing certificates.

Perpetual loans, however, do not accord with the

American custom. Entirely aside from considerations of security, there are good reasons why bonds should have definite dates of maturity. Technically speaking, there is no such thing as a perpetual loan, as no advance of funds is a loan, or credit, unless accompanied by a definite obligation to repay. There is no obligation to repay a perpetual loan, except upon liquidation of the company's affairs. If no right resides with the creditor ever to demand payment of the principal, the advance amounts practically to the purchase of an annuity, payable perpetually to the extent of the annual or semi-annual interest.

Loans have definite dates of maturity, for the following reasons:

1. To enable the investor to ascertain occasionally by actual test the solvency of the obligor
2. To broaden and strengthen the bond market. Constant refunding keeps the market active, stimulates long-term borrowing, and leads to more efficient management as a credit necessity
3. To steady bond prices; perpetual bonds fluctuate in price in inverse ratio with the true market rate of interest upon such investment securities, while bonds with definite maturities are, as a class, tied quite closely to par or redemption values

4. To adjust the amount, form, security, or interest rate of the loan to the changing conditions or necessities of the corporation, or of the market.

2. *Effects of definite maturity upon bond prices.*— Altho it is explained more fully in the volume on "Investments," it is necessary here that the reader understand the effect of bond maturities upon market prices. The bond investor seeks safety, and a certain definite income in the form of interest. The interest is based upon the par value of the bond, but the investor may pay more or less than par for it. The real rate of interest which he receives, known as the yield, is therefore determined roughly by dividing the actual amount of annual interest by the actual cost of the bond. If, for instance, a perpetual bond bearing four per cent interest sells at par, one with equal security and marketability bearing three per cent interest ought to sell around 75. The yield upon the investment would be four per cent in both cases.

With a ten year maturity, however, the three per cent bond would not sell as low as 75, to yield four per cent, but would have a market value around 90. If it did sell at 75, the yield would be about 5.5 per cent, because there would be added to the 3 per cent interest about 2.5 per cent annual appreciation in value, due to repayment in ten years at 25 per cent more than the cost of the bond to the investor. The

three per cent bond, maturing in ten years, would therefore sell, other things being equal, about fifteen points higher than the three per cent perpetual bond. The difference is due to the early maturity of the ten year bond and to the fact that it was purchased at a discount. The nearer an issue of bonds approaches maturity, the narrower will be price fluctuation above or below par, since the premium or the discount constitutes an element in the yield. As the market yield upon good bonds goes up, the prices of existing issues, as a whole, go down. The reverse is also true, prices of bonds increase as the market rate of interest decreases. American investors usually prefer the stabilizing influence of definite maturities to counteract this speculative influence of the market.

3. *Refunding versus amortizing.*—When the security behind a bond issue remains constant or increases with time, and the company desires to retain the use of the capital which bondholders have invested, a definite maturity date for the whole issue is ordinarily fixed for a term ranging between twenty and one hundred years. Railway bonds furnish the best example of this class. The company does not expect to retire the debt when it matures, but it does expect to pay the individual bondholders. The payment of the bondholders, at the same time renewing the debt, is accomplished by a process called refunding, which means merely that another bonded debt is created, from the proceeds of which the maturing bonds are paid off. The old bonds are superseded by a new

issue and the company continues in the uninterrupted enjoyment of the capital.

The principal purpose of frequent refunding is to adjust the debts of the company to changes in the condition or extent of its assets or business, or to improvements in the bond market. A railroad, for instance, which borrowed in 1900 at 4.5 per cent, may be able, owing to its improved credit, to refund in 1920 at four per cent, thus saving annually thereafter a substantial amount in fixed charges. This explains why, while high money rates obtain, corporation notes, or bonds of short maturity, are sold instead of long-term bonds, and why it is customary to make the bonds redeemable at the option of the corporation.

To refund a debt means to renew it in new form, but to amortize a debt means actually to pay it off. The full debt can probably not be paid out of the current profits or liquid assets available at the time it matures. Therefore, if the debt is actually to be paid off, some provision must be made for gradually retiring the bonds, or accumulating a fund with which to retire them at maturity. This process is known as amortization. Bonds are amortized, as a rule, only when it is felt that they cannot be refunded; in other words, when they are based upon a diminishing asset, or upon a business which is not regarded as possessing great stability. The business itself may be a good one, and yet subject to such rapid change or development that assets mortgaged now would be practically worthless ten years hence. Manufacturing assets are

for this reason difficult to borrow upon for long maturities. When secured by wasting assets or diminishing earnings, the necessity of bond amortization is clear. Whether the reduction results from diminished quantity, quality or earning power of assets, is immaterial.

4. *Basis of amortization.*—The security of a loan may consist of the market value of a product, structure, or natural resource, or of the earning power of a business. The bonding value of property of any kind is based upon its productive capacity, or "value in use." An asset is worth only what it will produce. If, in the course of production, the value of the specific security declines, it becomes necessary that the bonded debt be retired at least as rapidly as the assets upon which it rests are consumed. Such assets are known as wasting assets. Any natural resource or stock of goods which is exhausted in the course of business is a wasting asset.

Any specific structure or piece of equipment is a wasting asset, because deterioration caused by time or use, or both, is inevitable. On the other hand, a given lot of equipment which is being constantly replaced and improved, so that its productive value as a whole is maintained, may not be considered as a wasting asset.

The basis of amortization is therefore found in the nature of the security pledged, by allocating the causes of the wasting values. These causes are three in number:

1. Depreciation in earning power, caused by time or operation
2. Reduction of assets by sales
3. Decline in value owing to changes in the market.

Resulting from the nature of these causes, there are two bases of amortization:

1. Upon the unit of time—debt amortized at a certain rate per year, or other unit of time
2. Upon the unit of production or sale—debt amortized at the rate of so much per ton of coal mined, per thousand feet of timber cut, per acre of ground sold, etc.

To illustrate.—Bonds upon specific railroad equipment or single steamships usually mature serially, and are paid off in perhaps ten even annual payments, because time is the chief cause of their deterioration. Coal bonds are retired out of a fund accumulated at the rate of from three to five cents per ton mined, because production, which reduces quantity on hand, is the factor determining the diminution of the security.

Failure to observe these underlying principles and to distinguish clearly between them has resulted in numerous unsuitable, and often unsuccessful, provisions for amortizing bonds. It should be observed that the first and third causes, above mentioned, possess a sufficient element of uncertainty to produce wide divergence of opinion. The rate of obsolescence, or

market decline, is purely speculative in most cases. Frequent errors of judgment in the rate of amortization, therefore, often result, even when the governing principles are clearly recognized.

Sometimes borrowers are hampered by arbitrary sinking-fund demands on the part of investors, who, lacking faith in the future of the business, seek rapid amortization as a protection. The protection that they should actually have, in such cases, is often not amortization at all, but an intelligent policy governing capital investments, maintenance, surplus and dividends. Bonds should never be amortized without good reason, but when amortization is necessary its true principles should be recognized and applied.

5. *Test of amortization.*—The desirability of any given plan of amortization may be tested by the following five considerations:

1. Adequacy of the sinking fund or redemption payments
2. Certainty of payments
3. Reasonableness of the distribution of the burden upon the corporation
4. Effect of the plan upon the market for the bond
5. Expense and labor involved in the plan.

The application of these considerations will presently be shown. It will be noted that the first two are for the protection of the creditors, and that the last three are important to the borrowing corporation.

The creditor is interested in knowing that the plan is enforceable, the payments certain, and the amortization provision ample to protect him against any decline in the value of the security. The borrowing corporation is interested in securing a just, gradual and perhaps even distribution of its payments, so that it may be able to make them out of income without distress. The company also desires a plan which will involve as little inconvenience, uncertainty and expense as possible, and which will enable it to market the issue to the best advantage.

6. *Methods of amortization.*—The methods of amortization may be summarized as follows:

(a) Retirement in series or by allotment.
    1. Bonds maturing serially
    2. Periodical retirement by purchase in open market
    3. Periodical retirement by allotment and advertisement.

(b) Redemption fund accumulated against maturity.
    1. Fund held by trustee in bank
    2. Funds invested by the trustee in outside securities
    3. Funds invested by the trustee in bonds of the same issue, which are kept alive in the fund.

It is a good policy for a corporation to borrow, and for the same reason it is a good policy not to amortize

the loan under any plan unless it is demanded by investors or by the nature of the risk. If the profit of the business or the value of assets is enduring enough to justify the expectation that the protection of the bondholders will remain constant or increase, it is usually unwise to provide for amortization. Serial repayment is a clumsy device, not frequently used when it can be avoided. Amortization by redemption fund is more frequent. The words "sinking fund" possess charm to many investors, who perhaps consider them a sort of life-saving device, much as the housewife regards her "Christmas fund" at the bank.

7. *Unnecessary sinking funds a source of loss.*—If the funds are held in cash by the trustee under the mortgage, the amount in bank will not average over 3.5 per cent interest, whereas the company is perhaps paying 5 or 6 per cent upon its bonds and losing the difference. If the sinking fund is used to buy and retire its own bonds, the company is in the position of taking capital out of its business, which is earning perhaps upward of ten per cent, in order to save five per cent interest, and of course the difference is lost. If the trustee invests the sinking fund in securities other than those being amortized, he cannot expect to earn safely more than four or five per cent thereon, and the company loses the difference between this and its own rate of earnings. Furthermore, if the funds are invested in outside securities, the company takes the risk of stock market fluctuations and of tying up the funds so that they will not be

available to meet the bonds at maturity. Unnecessary sinking funds, therefore, bring loss to the corporation.

The investor himself often loses security in demanding sinking funds, for the reason that the increased earnings of the business, resulting from reinvesting profits in productive assets instead of setting aside a sinking fund, will frequently increase his margin of security. Especially is this true if the sinking fund requirements impair the ability of the company to maintain its plant in the best condition and operate on the most efficient basis.

If there is no redemption fund, restrictions upon dividends may be necessary in order to make sure that the surplus earnings go back into the property rather than into the pockets of stockholders. Needless to say, sinking fund requirements always depress stock values, since they constitute a fixed charge which frequently makes dividends impossible.

When amortization is necessary, however, owing to the fact that the bonds are based upon wasting assets, or that the business of the company is of a temporary or hazardous nature, what form should it take? Let us examine in a general way and without regard to the many exceptions which might be advanced, the applications of the five considerations above stated to the various general forms of amortization that have been mentioned.

8. *Serial bonds.*—Bonds which mature serially are objectionable from the standpoint of their effect upon

the market for the issue, and usually also because they do not, as applied in practice, properly distribute the burden of amortization for the company. Take, for instance, a bond issue of $1,000,000, maturing at a rate of $100,000 a year. If this issue bears five per cent interest, the company will have to pay, at the end of the first year, interest and sinking-fund charges aggregating $150,000, while at the end of the tenth year these will amount to only $105,000. These charges are not evenly distributed and fall upon the company most heavily during the earlier years, when it is least able to bear the burden.

Of course, these payments could be averaged so that the sinking fund payments would be lighter in the earlier years, the interest and sinking-fund payments together equaling ten even annual instalments. But in practice this is not done, because serial bonds are issued, as a rule, only against equipment which depreciates at a horizontal or constant rate, and is therefore thought to demand equal annual payments upon the principal of the bonds. The rate of depreciation will not adjust itself to the financial convenience of the corporation. The writer doubts the wisdom and necessity of this practice. The investor should realize the fact that his principal and his interest come from the same pocket, are equally important to him, and bear equally hard upon the corporate finances.

Obviously, the various maturities, when the issue is offered in the market, will appeal to different classes

of investors and will sell at different prices. Why this is so has already been made plain in the early part of this chapter. At first glance, it might seem that the various maturities, by appealing to different classes of investors, would tend to broaden the market for serial bonds. On the contrary, they tend to restrict the market, for the reason that there will be ten different prices and ten different market quotations for the same issue of bonds. Even figured out on the basis of yield, the quotations will differ, because the short-term issues will sell more nearly on the basis of commercial paper, whereas the longer maturities will be taken up by regular bond investors. This is probably one reason for the slow awakening of the public to the high investment merits of equipment trust bonds, which are as a class one of the best, if not the very safest, of American securities.

9. *Sinking-fund bonds payable by annual allotment.*—The repayment of bonds by annual allotment has at least the advantage over serial bonds of permitting one quotation for the entire issue. The uncertainty attending time of payment, however, renders them distasteful to the permanent bond investor, who desires a continuous income that will not disturb his principal. He is put to some inconvenience, and perhaps loss of interest, in changing his investment, and the company must therefore offer a premium to make such bonds look attractive in the market. The trust deed may direct the trustee to purchase annually, by allotment, a certain portion of the issue at 105, or

some other stated premium. This premium lends to the issue a speculative element that oftentimes more than compensates in the market for the otherwise unfavorable terms of payment. Of course, the premium adds to the expense of the company, and thus increases the actual interest rate which it pays for the loan.

A fixed redemption price in the trust deed prevents any speculative loss or gain by the company in redeeming its bonds by allotment. When the market price is lower than the fixed price, the trustee will of course purchase in the open market, if that right has been reserved to him, thus saving something to the company and avoiding the necessity of making an allotment. Any buying by the trustee, whether in the open market or by allotment, tends to strengthen the market. It is usually considered better financial policy to retire bonds annually by allotment than by serial maturity, for reasons just stated.

When the allotment plan is used to amortize bonds, the funds are first paid to the trustee by the corporation under the terms of the trust deed. The trustee then draws by number the bonds to be retired and advertises them in the newspapers with the redemption price. As these bonds come in, they are either canceled, or are kept alive in the sinking fund drawing interest, stamped "Purchased and held for the sinking fund." The same disposition is made if the bonds are purchased in the open market, but in such case the fluctuation of bond prices will prevent the fund payments

from working out with exact mathematical accuracy. If the trustee has the option to pursue the most advantageous course, he will buy in the open market, unless the market price is higher than the stated redemption price, in which case he will purchase by allotment.

There is no necessity for keeping the bonds alive and drawing interest in the fund after purchase. This plan was evolved to even up the burden upon the corporation by making constant both the interest and the burden of the debt. The same thing may be accomplished, and with less risk and labor, by canceling the bonds immediately as paid, and simply arranging the payments by scientific sinking-fund methods, so that the annual amount paid on interest and principal will total a constant sum sufficient to liquidate both in the number of years desired. It has already been made clear why the sinking fund should not be held in cash or invested outside. The plan here indicated, of amortizing by annual purchase, to the best advantage in the open market or by allotment, bonds to be canceled as bought and payments made constant by scientific schedule, is in most cases, the best plan to follow when the amortization is necessary.

One thing should be clearly understood, however. No fund is in any sense a sinking fund which is reinvested in the property or business of the debtor company. Such a policy of reinvestment may be preferable in many cases to the maintenance of a sinking fund, as provided, for instance, in the trust deed of

the San Diego Consolidated Gas and Electric Company first-mortgage bonds. A sinking fund consists of funds which have been set aside for the purpose of paying a debt. Funds reinvested in the business have not been set aside, nor are they available for the payment of debt, nor may they be called sinking funds.

REVIEW

Why are bonds commonly issued with definite dates of maturity?

Describe the operation of refunding and distinguish it from amortization.

Explain the bases of amortization and how the plan may be tested.

Explain the operation, the advantages and the disadvantages of sinking funds and of serial bonds.

CHAPTER XII

CAPITALIZATION

1. *Over-capitalization versus stock-watering.*— Having examined the nature of corporate capital and the instruments by which it is obtained, it is next in order to discuss limitations upon the use of these instruments. Our reader is referred again to a careful consideration of the definitions in Chapter II. Two basic definitions were given: capital, referring to the assets of the corporation; and capitalization, referring to its outstanding securities. The term capitalization has two uses, one quantitative, relating to the total amount or par value of the securities; and the other qualitative, referring to the kind of securities issued. The latter, for purposes of distinction, has been referred to as the "plan of capitalization." The nine chapters just preceding have described the principal securities, or elements, which enter into this plan, and the appropriate uses of each. It is the purpose of this chapter to discuss capitalization from the quantitative viewpoint.

Capitalization may be defined as the total par value of the outstanding capital stock and credit instruments of the corporation. This is its commonly accepted meaning. With some few exceptions, the law permits corporations to borrow on the best terms available; in other words, to sell bonds or other credit

instruments at any price obtainable. But stock is presumed to be sold only at par or above. The legal inference is, therefore, that the capital and the capitalization are originally equal, except for the discount lost or premium earned from the sale of bonds or notes.

The par value of the stock issued is presumed at law to equal the actual value of the assets obtained by its sale. If the par value is greater than the actual value of such property, the company is said to be over-capitalized, and the stock is worth correspondingly less than par. If, however, the net assets of the corporation exceed the par value of its outstanding stock, the company is said to be under-capitalized, and the shares are worth correspondingly more than par.

With a free and active market, not subject to manipulation, the price of the security registers the value assigned to it by the investing public. While these transactions are not exact indications of actual value, they are accurate enough to serve as a test of capitalization. As a general rule, it may be said that in a normal market a price averaging less than par over a period of time indicates over-capitalization, while a price above par indicates under-capitalization. The "flock" of securities sold chronically upon the exchanges at prices far below par indicates the vast extent of over-capitalization in the United States.

Many futile discussions and erroneous conclusions have resulted from failure to distinguish clearly between over-capitalization and stock-watering. Stock-watering is the process of intentionally issuing capital

stock for overvalued assets. In other words, it is intentionally issuing stock of a par value greater than the actual value of the capital obtained for it. Stock-watering is only one of the causes of over-capitalization. Over-capitalization and under-capitalization are in many instances inevitable conditions which cannot be intelligently criticized as such. Stock-watering, however, as a method of over-capitalizing, is subject to serious criticism.

2. *Causes of over-capitalization.*—Any one or more of the following conditions may result in over-capitalization:

1. Stock-watering
2. Depreciation of capital assets
3. Losses from operation
4. Losses caused by disaster or an act of Providence.

At the outset, a new corporation cannot be over-capitalized unless there has been stock-watering, or bonds have been sold at a discount. The discount on bonds may be considered an addition to the bond interest, and as such it becomes an operating expense.

Insurance may be carried now against loss from almost any act of Providence, and this is the least frequent cause of over-capitalization. The hundreds of millions of dollars' worth of corporate property destroyed in the devastated war districts of Europe and by alien enemies in the United States just before its entry into the World War clearly illustrates the opera-

tion of this cause of over-capitalization, which cannot well be controlled by the management of the company.

Any company may waste capital by doing business at a loss, or reduce it by paying out dividends without first making adequate provision for maintenance. Altho capital assets may depreciate, profits are nevertheless sufficient in many cases to enhance greatly the value of the business, calculated upon the basis of its earning power. In this event, actual depreciation of plant may occur, and yet the business may be under-capitalized. Over-capitalization itself is not an evil, nor can it be prevented by law any more than losses in business may be prevented by statute. Certainly no law can either prevent a business from losing money, or its assets from depreciating or from being destroyed by act of Providence.

Stock-watering, however, is both intentional and preventable, and without question it is often employed to deceive the unwary. On the other hand, stock-watering seems to be a financial necessity in promotions. It is by no means easy to legislate out of existence the evils of this practice and at the same time retain its benefits.

3. *Bases of capitalization.*—Considerable confusion of thought arises because of the frequent failure to distinguish capitalization from valuation. No one, for instance, ever thinks of capitalizing a business upon the cost of its reproduction, and yet that basis is mentioned by a number of leading authors. As a matter of fact, valuation is more important than

capitalization. The total par value of the outstanding securities is immaterial, but it is very important to know the actual value of the property. Any one or more of the following may serve as a basis of valuation:

1. Actual cost
2. Cost of replacement
3. Earning power
4. Cost of reproduction.

Only three of these, however, are ever used as a basis of capitalization. The four bases of capitalization are:

1. Actual cost
2. Cost of replacement
3. Earning power
4. Estimated willingness to buy, or gullibility, of the investing public.

If the promoters are on the water wagon, and the capitalization is "dry," the actual cost serves as the basis, with capitalization increasing no faster than capital as funds are required to expand the business. Adherence to this practice would cut out stock-watering, but unfortunately it would also prevent the promotion of many large corporations. As a rule, therefore, cost is a basis of capitalization only when the business is small or closely owned. But cost is not necessarily a conservative basis of recapitalizing an old business, the value of which may have no relation

whatever to its original cost. Recapitalizing at cost may still leave the stock highly watered if the assets have deteriorated.

The cost of reproduction refers to the present cost of producing a property similar to the old property in specifications and condition. The cost of replacement refers to the present expense of replacing the old property by a modern type of equivalent capacity. The cost of reproduction is not a basis of capitalization, because no one thinks of reproducing an old property, but rather of replacing it. Capitalization is regulated to suit the investor, and the investor is interested only in what the property will earn, or what it will cost to replace it.

Earning power is the usual basis of capitalization. The securities of a business are worth only what they will earn; in other words, the par value of the securities is fixed at an amount upon which the estimated or actual income of the concern will pay the market rate of interest. For instance, a certain company has $60,000 available for bond interest and is able to issue bonds which investors are willing to purchase upon a six per cent yield. It may issue bonds to the extent of one million dollars. The earning power has determined the amount of the capitalization. Another corporation, with the same amount available, but able to borrow on a five per cent basis, might issue $1,200,000 in bonds against the same earnings. This process is called capitalizing the earnings.

It should be noted, however, that often the earnings are only estimated, or imaginary. When a run-

ning business is capitalized, earnings may be the real basis. If it is a new business, however, earnings may be the excuse, but imagination is the real basis. The actual basis in such case may be the amount of stock which the promoters think the public can be induced to buy. This is practically always the case with mining companies, and, as to common stock, it was the basis of capitalizing the majority of the so called industrial trusts. Most of the great industrial combines of the past twenty years based their bond and preferred stock capitalization upon estimates of real earnings, but their common stock capitalized nothing more tangible than the anticipated economies of market control or large-scale production and distribution.

Earnings are always mentioned as the basis of capitalization, even in the wildest dreams of mining company promoters. In this case, a great deal of talk about estimated earning power is used to cover up a capitalization that really is based upon another principle, namely, the maximum amount of stock which the promoters think the public can be induced to buy. This is actually the basis of capitalization in a large percentage of speculative companies, numerous examples of which might be mentioned. The writer has in mind one such recent company which issued stock to the extent of a million and a half, par value, upon assets costing only a few thousand dollars. The rest of the capitalization represents hope. It is plain

that earnings, cost, cost of reproduction, and cost of replacement had nothing to do with determining this capitalization, but of course the prospectus talked mainly about earnings.

4. *Objections to stock-watering.*—Numerous objections are made to the practice of stock-watering, especially that it:

1. Results in higher prices, charged to pay dividends on excessive capitalization
2. Encourages unnecessary competition, with consequent duplication and waste of capital
3. Results in the sale of many worthless securities to the uninformed public.

Let us examine these contentions briefly. Prices are fixed by demand and supply. When a normal competition exists in supplying any commodity or service, all demands will be amply filled until profits fall below the minimum which the owners of capital in that business are willing to take. Under these conditions prices are fixed by the cost of production and the necessities of competition, and not by each producer arbitrarily to meet his own dividend requirement. If producers can raise prices merely because their capitalization is increased, there is nothing to prevent them from raising prices without increasing capitalization. If we adopt the stand, therefore, that stock-watering increases prices, we must assume that producers who have not watered their stock are charg-

ing less than they can get, from purely philanthropic motives. It is safe to assume that corporations always charge about all they are able to get for what they have to sell, regardless of the number or amount of outstanding shares of stock.

5. *Stock-watering by public utility companies.*— Under monopoly conditions, however, competitive prices do not exist, and charges are based upon what the controlling company is able, or permitted by the government, to charge. Unless artificial restraints are introduced, the monopoly will collect all that the traffic will bear. This explains why the laws of the United States prohibit monopoly and restraint of trade, and why public utility corporations, operating essentially under monopolistic state charters granted by the state, are subject to special legal restrictions and to close supervision in the public interest.

In this connection, it should be noted that stock-watering has often been resorted to by public utility companies for the purpose of covering up excessive charges which they already have the power, but not otherwise the nerve, to collect. Public service franchises are almost always monopolies, of necessity. It would be ridiculous, for instance, to have more than one water company, or more than one street-railway company, in a city, duplicating each other's facilities, and engaging in cutthroat competition. It would be equally foolish for capital to engage in the duplication of railway service which is already adequate. Such public utilities, however, are practical necessities

of business life, and since they are owned by private capital, their service, rates, and capitalization must be subject to careful public regulation.

Stock-watering is no longer of much service to public utility companies in covering up excessive rates, as the public utility commissions and courts now restrict rates to a reasonable return upon the actual valuation of the property and franchises, without regard to the amount of outstanding securities or the desire to pay dividends upon watered stock. This fact is gradually becoming known to the investing public. Altho in many states watered stock may still be issued by public utilities, the commissions have been granted power in several of them to supervise the capital investments of such companies and to prevent the further issue of watered stock. The water is gradually being wrung out of their capitalization. It is doubtful whether anything more is needed to prevent stock-watering by public utilities than a wholesome and gradual continuance of the present development of commission control, accompanied by full publicity in the affairs of such companies.

That the ability of any company with watered stock to pay large dividends is an inducement to others to enter into competition, cannot be doubted, but the same inducement exists whether the stock is watered or not. It is not the stock-watering, but the large profits resulting from the discrepancy between demand and supply, that causes the new competition. The writer believes that stock-watering has nothing

whatever to do either with the unnecessary duplication of competing facilities or with the fixing of prices.

6. *How par value fools the public.*—The last criticism leveled at stock-watering, namely, that it results in the sale of stock to the public at exorbitant prices, has more to support it. As a matter of fact, this is usually the purpose of stock-watering. As long as there is an investing public, gold bricks will be sold. If investors spent one-tenth of the energy studying finance, that they spend sitting before brokers' boards reading meaningless figures, hunting for tips, and feverishly absorbing the daily mass of false information that is carefully prepared for them by hungry promoters, the hallucination of par value would not long exist.

We refer to the beautifully engraved and seriously funny words appearing upon stock certificates, "of the par value of $100." Or the par value may be $50, $10, or $1, according to the state of mind or the financial ability of the intended victims. A man died recently leaving stocks exceeding a million dollars, par value, but the executors appraised them at $200.

It seems to the writer that the whole evil of stock-watering is found in the unconscious significance which poorly informed investors place upon par value. There is no doubt that par value fools the uninitiated, and encourages swindling. The theory of the law itself seems to lend some significance to par, as, under the law, stock is not supposed to be issued until it has

been paid for at its full par value. Does not this antiquated law foster deception?

Par value has no significance in common stock. It would make no difference in the actual value of its property or its capital stock whether the mining company which cost a few thousand was capitalized at $1,500,000 or at $15,000. In either case, this particular company would be over-capitalized. Upon maturity, bonds are supposed to be paid off at par, but in common stock the words have no further service than to carry a false inference of value. There is much irony in printing the word "value," with this arbitrary $100 mark, upon the face of a ten-cent mining certificate. But we shall have to admit that it is often a decided success.

7. *Proposed remedies for stock-watering.*—Of the various remedies proposed for this situation, two of some possible value may be mentioned:

1. The removal of par value from common stock certificates
2. The issue of new securities only upon certificate of approval by some public authority, stating the facts regarding the promotion and the manner of payment of capital stock.

New York State already has a law permitting the issue of stock without par value. The certificate merely states the number of shares which it represents and the total number of shares which have been authorized. Each owner is thus able to calculate the

proportion of the corporation which he owns, but he is under the necessity of placing his own value upon it. Market quotations are upon the basis of so much per share, and there is no limit to the number of shares that may be issued. The corporation is taxed upon the basis of its actual capital. If this practice should be uniformly adopted, it would, without question, go far toward removing the confusion which par value now brings to the mind of the uneducated investor.

Without par value there could be no such thing as over-capitalization, or stock-watering, but it must be distinctly remembered, on the other hand, that this would not prevent the sale of worthless shares to the public. It is the custom of those who sell blue-sky shares to assign to them an arbitrary price from day to day, and this is marked up occasionally to stimulate sales, until the whole issue has been disposed of. There is no market price in such case, altho the marked-up prices are often mistaken by the "investor" for real market prices.

Market price is one at which securities may be purchased or sold in the open market. The arbitrary price to which speculative securities are marked up for public sale is only the selling price for the promoters or syndicate. Investors would very soon see the true situation if they should endeavor to sell at that price in any large quantity. The removal of par value would not remove this practice of marking up stock values or of otherwise manipulating stock prices by

syndicate operations to a marked level above their actual worth.

It is probable that the injection of a larger measure of publicity, supported by more uniform and thoro accounting methods, and by statement of the facts behind all new stock offerings, would go far to eliminate the sale of deceptive or worthless securities. If those who promote or capitalize new companies were compelled to file certificates under oath, showing in detail the manner in which stock had become fully paid up, verified, perhaps, by a public appraisal of the property, and if the facts shown in such certificates were available to the public, it is probable that most stock swindling operations would cease.

8. *Benefits of stock-watering.*—Altho stock-watering is used to assist fraudulent promotion, care must be exercised not to cut off the head to cure the headache. Stock-watering is not harmful unless used to deceive, but is often a legitimate and beneficial process. It is only by this device that the promotion of many of our largest companies has been made possible.

As we shall see in a later chapter, the promoter, the bankers who undertake to get up the underwriting syndicate, and the members of the underwriting syndicate themselves must be well paid for the labor and risk which they assume in promoting and financing a new business. Usually large companies cannot be formed without the effort, skill and resources of the

promoters and bankers who bring together the opportunity and the capital to exploit it.

If they were to be paid in cash, the capital of the new concern would be impaired immediately and a much higher rate of return upon bonds and stocks would be necessary in order to induce investors to buy them. This higher rate of interest would throw such a burden of fixed charges upon the company that its financial stability might be endangered.

By over-capitalizing the company, however, the promoters, bankers and underwriters may be paid largely in common stock, which capitalizes the anticipated profits of the business. The bonds and preferred issues are sold to obtain capital, which is retained for productive use. This enables the corporation to borrow at a lower rate, keeps down fixed charges, improves the stability of the company, and maintains the interest of the promoters and bankers in the company for a period of months or years. By giving their services in exchange for a speculative security in the form of watered stock, they have voluntarily postponed their own remuneration, upon a speculation. They are remunerated by the sale of their common stock in the open market, perhaps when its value has been established upon a basis of earnings.

Of course, it is possible, and it frequently happens, that the stock is worked off on the public at highly fictitious prices thru syndicate manipulations, but this same thing can be done whether or not par value is assigned or stock-watering is resorted to.

We are forced to the conclusion that while stock-watering is an important factor in fraudulent promotion, and to some extent in the artificial manipulation of stock prices, it is not the cause of these evils, nor would the entire abolition of the practice of stock-watering prevent them. The prevention of capitalization frauds will probably be found in the more stringent governmental regulation of the issue of securities in exchange for property or services, the enforcement of greater uniformity and publicity in corporate affairs, particularly respecting capitalization, and the removal of par value from the stocks of mining and other speculative companies.

REVIEW

What is over-capitalization? How can it be ascertained? How is it distinguished from stock-watering?

Enumerate the causes of over-capitalization.

What are the difficulties which beset legislation directed against over-capitalization and against stock-watering?

Describe the different bases of capitalization, and the advantages and limitations of each.

State the objections to stock-watering.

What was the motive which led public utility companies to water their stock? How has this feature been corrected?

What is the true significance of the par value of stock?

Describe proposed remedies for stock-watering.

When is stock-watering beneficial?

CHAPTER XIII

INVESTMENT AND MAINTENANCE OF CAPITAL

1. *Gradual and efficient investment of capital funds.*—Many corporations sow the seeds of their failure in the first year of business by the unwise investment of capital funds. Many others, having tasted a brief success, gradually fall into the habit of careless capital expenditure.

Upon the productiveness of the investment depends the earnings and the success of the company. Experience and good judgment should guide the investment of capital. Many errors to be avoided are mentioned thruout these chapters. The financial considerations governing the extent and distribution of capital investment relate principally to:

1. The nature and size of the business
2. Productive capacity of assets
3. Flexibility of investment
4. Organization expenses and losses
5. Sufficiency of initial capital
6. Ability to interest additional capital as required.

Naturally the capital is invested in assets that are

appropriate to the business from the viewpoint of its size and scope. A large trunk-line railroad, for instance, would be likely to buy heavier locomotives than a small branch.

The productivity of assets is equally important. In certain districts and certain lines of business, for example, the motor truck may be economically employed for heavy hauling, but under other conditions horse-drawn vehicles are best.

The flexibility of capital investment is also important. If the company, for instance, is to manufacture a certain specialty which is subject to rapid change in market demand, it is wise to equip the factory so that other things may be produced with the same equipment. This makes it possible to convert the capital readily from one purpose to another to meet changing conditions. The more highly specialized the equipment the less it is worth to others and the greater the reserve required against its depreciation in value.

Capital investment cannot be most effective if a large part of the original capital is consumed in organization expenses and in meeting operating losses during the early years. The management, therefore, is interested in seeing that all unnecessary interest and cumulative preferred dividend charges are eliminated during the period of construction and early operation. Sufficient capital must be provided, but not an excessive amount or at a more rapid rate than needed.

If the amount required can be definitely estimated

in advance, subscriptions may be made payable as needed. If not, an elastic plan of capitalization is required which will prevent either an excess or a shortage of capital. As explained in Chapter II, assessable stock is unpopular and should not be issued if it can be avoided. Ventures of uncertain capital requirements are naturally quite speculative. In such cases, unless the company is to be intentionally overcapitalized, the advisability is suggested of offering common stock up to the estimated minimum requirements, and redeemable preferred stock for the balance up to the estimated maximum needs. If the demands for capital prove to be light, the preferred may be withheld entirely, or having been issued, may be retired at a slight premium. If legitimate capital requirements exceed the highest estimates, the excess may usually be borrowed.

The scheme of capitalization should preserve an avenue for expansion by leaving a way open for the issue of future attractive securities. If the company is profitable, or holds out good promise, this is not always difficult, unless the original investment of capital funds or scheme of capitalization has been bungled.

2. *Danger of large fixed assets.*—The most usual mistake of an inexperienced management is excessive investment in fixed assets, with consequent shortage of working capital. Ordinarily, a business is not judged by the appearance of the building which it occupies, but rather by its balance sheet and earnings. Fine buildings, expensive office furniture, or special

equipment will not constitute a good basis for loans and cannot easily be converted into cash. For this reason, great care should be exercised not to overinvest in fixed assets at the beginning. This mistake may often be avoided by renting at first only the necessary space and equipment. Especially is this good policy if the company begins business with limited capital. Permanent investment may be more safely made after the business has been established and a reasonable surplus created.

3. *Working capital.*—Working capital consists of that portion of the net assets which is not tied up in any fixed or permanent form. The chief forms of working capital are:

1. Cash
2. Accounts and bills receivable
3. Finished stock
4. Raw stock and supplies
5. Securities of other companies held for investment, not for purposes of control.

Working capital consists essentially of quick assets, such as are convertible into cash within a reasonable time in the ordinary course of business. Such quick assets, like fixed assets, are subject to great shrinkage in value in event of failure, and should always exceed by safe margin the short-time liabilities. The working capital is only the difference between the quick assets and the short-time liabilities. Some companies operate on a very narrow margin of working capital; a few, in fact, possess none at all. But many of the

larger producing corporations retain as much as half their entire capital in this form.

The volume of working capital depends upon the nature of the business, and it should be determined by taking into consideration:

1. Volume of the business
2. Distribution of purchases and of production and selling expense thruout the year
3. The credit terms upon which purchases are made
4. The credit terms upon which sales are made
5. The length of the period of production during which capital is tied up in work in process.

Most of these factors speak for themselves. A large business obviously requires more working capital than a small one. The regularity of purchases is an important factor. In the grape juice business, for instance, the entire stock of grape juice for the year must be purchased in September and October. The bridge-builder may at one time have no stock on hand and at another have large sums tied up in materials, pending the completion of a large contract. It is plain, therefore, that lines of business which purchase seasonally or irregularly, or sell likewise, require a large working capital because of the heavy stocks which they carry at times.

The credit terms, of both purchase and sale, have great influence upon working capital. If the company pays for its materials, say, thirty days net, and sells upon sixty days' time, it will require a much larger working capital than a company which buys

on sixty days' time and sells on thirty. The writer knows of several companies which have no working capital of their own, but deal entirely upon the trade credit which is extended to them, by buying on long terms and selling on short.

During the period of production, or pending resale of goods, capital is tied up by work in process. Some companies turn their capital several times each year and require only a small percentage of profit on each transaction, while others—for instance, builders of ships and office buildings—turn it less frequently, and consequently require a larger percentage of profit on each sale and a correspondingly larger working capital.

In this connection, the extreme importance of perpetual inventory, careful stockkeeping, avoidance of wasteful methods and the maintenance of minimum stocks need to be emphasized. It is better for the company to carry a somewhat smaller stock and a larger cash balance, under normal conditions, than to carry heavy stocks. The large bank balance improves the credit of the company, while the large stock often increases manufacturing cost and frequently encourages wasteful and careless methods. The larger the stock, other things being equal, the slower will be the turnover and the greater the working capital required.

4. *Cash requirement.*—What part of the working capital should be in cash? The answer differs with different lines of business, and with different com-

panies in the same line. But certain well defined principles are observable.

Cash lying in bank is non-productive. That is why the banks are anxious to loan it out at interest. On the other hand, it is important both to the customer and to the bank that a certain reserve of cash be on hand at all times, since neither is able to match receipts against expenditures exactly. An excessive bank balance shows poor management, but a lean one is likely to be regarded as a sign of financial weakness. As in most other things, moderation is the best policy.

A bank account of reasonable size is required principally for the following purposes:

1. To maintain adequate banking and credit facilities
2. To meet periodical payrolls
3. To pay for seasonal or irregular consignments of stock
4. To pay for seasonal or extraordinary replacements
5. To meet unusual expenses and losses, or to bridge over unusual delays in the collection of accounts.

A very small bank account would suffice, except for these irregular demands, all of which are either self evident or are elsewhere explained in this chapter.

5. *Outside investment of working capital.*—Working capital should be invested outside the business

only in certain rare contingencies when earnings are subject to extreme fluctuation.

If the investment in securities is for the purpose of exercising control over another company, it can scarcely be called working capital, but is rather in the nature of a fixed or semi-fixed asset. The amount invested in subsidiaries or outside competitive resources resembles closely the company's investment in its own plant, except that the securities perhaps may be more readily sold in liquidation than the fixed assets of the holding corporation. For this reason such securities are classed as semi-fixed assets, and are not working capital.

6. *Depreciation.*—In a general sense depreciation means a decrease in value; appreciation an increase. Decrease in value may be caused by:

1. Deterioration in physical condition, due to use or corrosion
2. Obsolescence
3. Adverse business condition or declining market
4. Destruction by accident or catastrophe.

In the chapter on Amortization these factors have been quite fully discussed. Not only does all physical property require constant repair, but it wears out in spite of repairs and must some day be entirely replaced. Improvements in the industry may render equipment valueless, in competition with newly invented devices which render the old equipment obso-

lete. Changing styles, the competition of a new or superior article, or any causes which affect the market of the product, depreciates the value of the plant which produces it. A new law may render many millions of dollars' worth of equipment practically useless. A prohibition amendment to the National Constitution, for instance, would depreciate distilling and brewing machinery many millions of dollars at one stroke. Earthquakes, lightning, floods, fires, riot, or war may cause serious depreciation which is both unforeseen and uncontrollable. Of these four causes of depreciation, all except the first are contingent or extraordinary, and cannot be closely determined or wholly guarded against by insurance.

Every part of a company's equipment or stock presumably enjoys a period of valuable service. The impairment of its value may be offset on the balance sheet by a depreciation reserve which makes good the loss within this period of service. It is true that good care, and prompt and expert repairs will lengthen the service, and thereby reduce the rate at which such property depreciates. It should be noted, however, that if the repairs are counted upon to lengthen the life of the asset, and the depreciation rate is adjusted accordingly, the cost of such repairs cannot be properly charged to the depreciation reserve, as it is to cover replacements only.

Care should be taken to distinguish between repairs, replacements and betterments. Repairs refer to current upkeep. Replacement means the substitution of

new equipment for old. Betterments consist of improvements which are intended to directly or indirectly reduce the cost of production or increase productive capacity. Repairs are chargeable current expense of operation. Replacements should be charged to reserves accumulated for that purpose, or to surplus. Expenditures for betterments may reach the balance sheet thru any of these accounts, or by increasing the capitalization.

7. *Rate and amount of depreciation.*—If the active life or period of service of any given asset is known, or may be closely estimated, the rate of depreciation may be had by dividing the number of years of active service into one hundred. The result is a percentage, which will, when multiplied by the cost of the machine, give the amount that should be set aside each year to provide for its ultimate replacement. This system takes no account of compound interest, but is considered accurate enough for most practical purposes. To illustrate.—If a certain machine costs one thousand dollars and has an estimated usefulness of eight years, by dividing eight into one hundred, we get 12.5 per cent as the rate of depreciation. On one thousand dollars 12.5 per cent is $125; the reserve which should be set up each year against its ultimate replacement. Repairs are in addition to this reserve, and are counted upon to maintain the machine in working order during the eight years.

In connection with the depreciation rate, attention is called to the necessity of ascertaining and applying

standards that have been developed in practice under expert observation. The mere guess of the manager or board of directors as to how long certain property will last, is neither necessarily correct nor likely to be so. In practically every industry, qualified engineers have found from experience the depreciation which applies under given conditions to each class of equipment. Unaccountable and incalculable variations in the quality, usage or upkeep make it impossible to apply an absolutely accurate rate in any case; but it can be made approximately correct so far as physical deterioration goes.

To apply a rate of depreciation, the present physical condition of the asset should be known, and a standard of condition maintained as closely as possible. The leading corporations keep a careful record of each piece of equipment, and the repair gangs are expected to maintain it as near as possible to a set standard. The reserve for physical depreciation of the corporate assets, as a whole, is then determined by adding together the annual amount of depreciation upon each unit. The cost department of nearly every large corporation has an inventory of its equipment, with the rate and amount of annual depreciation set opposite each item, and the total constitutes the depreciation reserve for the year against ordinary physical or market impairment of values.

Contingent and extraordinary depreciation cannot be calculated in the same manner. Several methods are employed of treating depreciation resulting from

obsolescence, changing legal and business conditions, or accidental destruction:

1. Nothing is provided against them in the belief or expectation that appreciation of portions of the property will offset depreciation from these three causes
2. Annual betterments to a certain extent are made out of earnings and charged to operating expense
3. A certain arbitrary amount to cover these losses is added to the annual depreciation reserve.

8. *Appreciation as an offset to depreciation.*—Very few fixed assets, except land, appreciate in value. Buildings, machinery and other equipment rarely increase, altho occasional causes, such as war, may put a temporary premium upon certain kinds. A very rapid and severe increase in prices, such as was witnessed during the World War, may, for the time being, apparently increase the value of fixed capital more rapidly than it depreciated, because of temporarily stimulated production and earnings. A decline in prices works in just the opposite direction, and, unless the asset is one which is to be sold during the period of high prices, in the regular course of business, the appreciation cannot be counted to offset depreciation.

Unless the appreciation can be traced directly into the income account, thru decreasing cost of production, or positively increased income from sales, it is scarcely available for any actual replacements. The appreciation of land values may not be realized until

the business is wound up or its plant relocated. Meanwhile no benefit is derived from the appreciation, and perhaps increased taxes are paid. The improved value, it is true, does enhance the company's capital and increases its borrowing power, but if considered as an offset to depreciation reserves, this policy is likely to necessitate the issue of new securities to obtain capital for replacements later.

9. *Depreciation reserve.*—A depreciation reserve consists of a certain portion of the annual earnings, or accumulated surplus, which is kept in the business or available to it, and which is accounted for on the books as an amount retained specifically for the purpose of meeting losses and replacements necessitated by depreciation of assets. Care should also be taken to distinguish between depreciation, reserve, surplus and sinking funds. Sinking funds are always invested outside the business, to retire, or in contemplation of retiring, a part of its debt. Depreciation, reserves and surplus, on the other hand, are retained in the business. All three have as their essential object the maintenance of the value of the capital stock; the reserve by maintaining the productive value of assets; the surplus by guaranteeing regular dividends; the sinking fund by retiring part of the company's funded indebtedness.

Neither upon the books nor in actual practice, is there any essential difference between reserve and surplus, except that actual surplus is a proper source of dividends, while reserves are not. The slightness of this distinction accounts for the fact that many com-

panies which possess a reasonable surplus do not provide reserves, but depend upon the surplus to take care both of depreciation and dividend requirements.

Reserved funds may take the following forms:

1. Cash
2. Invested in securities
3. Invested in the business.

The last seldom is the usual form, but generally the best. Cash reserves are rarely satisfactory for the reason that bank deposits rarely earn over three per cent. But reserves in cash or in the securities of other companies are sometimes desirable to provide self-insurance, regular dividends, or large replacements which cannot be paid conveniently out of current income. In the absence of some special reason, reserves in the form of cash or securities possess the same objections as unnecessary sinking funds, mentioned in the chapter on Amortization.

Secret reserves may be carried which do not show upon the books, by charging betterments to operating expense. This has led many to believe that reserves are merely a matter of book entry. Altho reserves or surplus may be actually kept without appearing on the books, to do so intentionally is haphazard policy, which is not to be recommended except, perhaps, as a form of necessary manipulation to save a corporation from dividend-mad stockholders.

There are some companies, such as railroads and

street railways, which need carry little or no reserve against the bulk of their assets, for the reason that they undergo a constant process of replacement and improvement, which renders reserves unnecessary, except against large units such as terminals, freight and passenger stations, bridges, etc.

10. *Financing betterments.*—Betterments are of two classes, those which immediately increase the income and profits of the company and those which are slow and uncertain in their effect upon earnings.

It is obviously sound policy to borrow, or to issue additional stock, to finance improvements which will pay immediately. But betterments which do not increase the income sufficiently to pay the interest upon their own cost, cannot safely be financed in this way to any large extent. Such improvements had best be paid for, either wholly or in part, out of current income, either as a charge against surplus or out of a special reserve created for the purpose.

REVIEW

Explain how the capital investment affects the operations of a company. What dangers lurk in large fixed assets?

Distinguish between fixed assets and working capital, and explain the factors which determine the amount of the latter.

How much of its working capital should a company hold in cash?

Under what circumstances may it be appropriate to invest a part of the working capital outside the business?

What is depreciation and how may an annual rate be determined?

Is appreciation to be depended upon as an offset to depreciation?

How do companies provide for depreciation?

CHAPTER XIV

INCOME, DIVIDENDS AND SURPLUS

1. *Income statement.*—The financial policy of a corporation cannot be intelligently determined without a fairly accurate knowledge of its present condition and operating results. If the business is well systematized and the transactions properly recorded upon the books, the present condition will be reflected in the balance sheet, which sets out in more or less detail the assets and liabilities of the company. The extent and profits of current operation, however, are summarized in the form of an income statement. For details the reader is referred to the Texts on accounting subjects.[1] It is necessary here to discuss briefly the income account, since the policy regarding dividends and surplus depends directly upon it.

The usual form of income statement, subject to many variations, is as follows:

Operating revenue	$1,000,000
Operating expense	700,000
Income from operation	300,000
Income from other sources	100,000

[1] Vol. 9, "Accounting Principles"; Vol. 21, "Accounting Practice and Auditing," and Vol. 22, "Financial and Business Statements."

Gross income	400,000
Deductions for fixed and contingent charges	200,000
Net earnings	200,000
Dividends	100,000
Carried to surplus	100,000

If business has been conducted at a loss, the deficit for the year is a charge against previous surplus, or, in the absence of surplus, it directly impairs the capital of the company. In such case, there is nothing to discuss concerning dividends and surplus, because there are no earnings to divide.

2. *Sources of income.*—Operating revenue should be classified according to the kinds of business carried on. Operating expense includes the cost of maintenance and of the material, labor and supplies required to run the business. To the income from operation must be added income from other sources, such as interest and dividends upon the securities of other companies, rentals from property owned, interest upon bank deposits, gifts to the corporation, and premiums earned upon the sale of capital assets or of additional stocks and bonds. Income from miscellaneous sources is likely to be irregular, has no direct relation to operating income and should, therefore, be separated from it.

From the gross income thus derived, all fixed and contingent charges such as interest, rental, taxes, etc., must be met. The amount then remaining is the actual net earnings of the company, available for divi-

dends. The portion of the net earnings not paid out to stockholders is retained in the business and carried to the surplus account.

Unless the income statement is made up honestly and accurately, it is of no value. Unfortunately many American corporations keep such unsatisfactory records that they are unable to present an accurate balance sheet or income statement. The cost of operation should include a liberal allowance for depreciation, and sinking-fund contributions should be included with fixed charges. Sinking funds and depreciation reserves have been discussed in previous chapters.

3. *Sources of dividends.*—It has been said that dividends are the only unproductive expenditure which an honest and efficient corporation makes.

If the dividends exceed the net earnings of the current year, they must be paid out of the accumulated surplus. If they exceed the actual surplus, they impair the capital of the company and are illegal, unless a reduction of capital is formally authorized by the stockholders.

If the capital has been previously impaired, current earnings may be required to restore it, and in such case are not properly available for dividends. There can be no real surplus unless the capital has been kept intact, but, where a surplus does exist, dividends may be paid out of it in the absence of special restrictions, whether dividends have been earned in the current year or not.

The surplus may be designated as undivided profits, profit and loss, income account, or surplus income. The title used to designate surplus is unimportant, but it should never be confused with actual reserves or sinking funds. The surplus of a corporation consists in the difference between its assets and its liabilities, including the capital stock as a liability. Actual reserves and sinking funds, on the other hand, are not in the business, but are amounts set aside from the business for some specific purpose, and are not available for the general uses of the corporation.

4. *Kinds of dividends.*—Dividends may be paid out of either the assets or a dividend reserve previously created. Sometimes the initial losses sustained in organizing a corporation and bringing it to a profitable basis are entered as assets upon the books, in the form of good-will or organization expense, and conservative financial practice insists that such losses be made good out of income before any dividends are declared.

5. *Cash dividends.*—Dividends may be paid in cash, other property, script or capital stock. The cash dividend needs no comment. Property dividends, however, are unusual and deserve mention. It sometimes happens that a company desires to pay dividends by the distribution of property other than cash. This is particularly true when a corporation, altho a dividend has been earned, desires to keep its cash and to dispossess itself of certain other property which is available for distribution to stockholders. The most usual form of property dividend consists

of securities of other companies which may be readily assigned to stockholders. Land, buildings and machinery do not readily lend themselves to distribution in this manner, altho dividends by the distribution of parcels of land or corporate products are not unknown.

Since the outbreak of the European war, some corporations, particularly those engaged in manufacturing war materials, have paid part of their dividends to shareholders in the shape of government bonds. The Du Pont Company, for instance, in February, 1916, declared a special dividend of 22½ per cent on the common stock, in addition to the regular quarterly dividend of 1½ per cent. Dividends were payable 5 per cent in cash and 19 per cent in Anglo-French bonds, with coupons attached, at 95. The Canadian Fairbanks Morse Company took somewhat similar action in April, 1916. After providing for the preferred stock dividend, the 1915 balance available for distribution on the common stock was $619,048, as against a deficit of $191,099 in the previous year. Earnings on the common stock in 1915 were equal to 33.7 per cent. In view of the fact that common stock dividends, formerly at the rate of 8 per cent per annum, had to be discontinued in 1914, the directors, in addition to a cash dividend of 4 per cent paid during 1915, declared a dividend of 12½ per cent payable in Canadian war loan bonds; a distribution of $200,000 in all.

Cash dividends come directly out of the bank ac-

count, and often necessitate short-term loans pending the receipt of assured income which will replenish the bank balance. Cash dividends should not be paid if the money is needed in the business, even tho dividends are earned. Many a really successful and profitable concern has been forced into reorganization by borrowing cash for the purpose of paying dividends when working capital was already too low.

6. *Scrip dividends.*—Scrip dividends are merely notes of the corporation paid out in lieu of cash. They are rarely justified and usually indicate financial difficulties. The issue of scrip does not differ in form from the capitalizing of earnings by the issue of bonds, except for the shorter term of scrip. Ordinarily it is better, when dividends have been earned but cannot be paid in cash, to declare stock rather than scrip dividends, if any dividends at all are paid.

7. *Stock dividends.*—The stock dividend consists of the issue of additional capital stock to the extent of the dividend. This capitalizes the profits of the concern and keeps the funds in the business. The stockholder realizes his dividend by selling the stock, or, by retaining it his dividend income may be increased. When stock dividends have been declared, it is customary for the corporation to continue paying the former rate of cash dividend upon all the stock, which increases the stockholders' income by the amount of the annual dividend upon the new stock. The stock dividend is merely a compulsory subscription to additional capital stock of the company, and

is an indication of inadequate capital, concealed earnings or excessive surplus.

8. *Privileges.*—Corporations whose stocks are drawing heavy cash dividends, and are therefore selling at a premium, will sometimes distribute dividends to stockholders in the form of privileges to subscribe to additional stock at par or at some stated figure above par. The difference between the subscription price and the market value of the stock represents a dividend to the stockholder, who may realize his profit by marketing the shares.

This right, or privilege as it is called, is evidenced by a letter or certificate which may be sold and assigned, and listed upon the stock exchange in the same manner as capital stock. It merely gives to the holder the right to subscribe to a certain number of shares of stock at a stipulated price. The right is worth the difference between the value of the stock and the subscription price. This right is likely to form the basis of speculation, whereas the stock dividend is more likely to go into the safe deposit vault. The stockholder in the financial market who understands rights has a direct advantage in dealing in them.

9. *An illustration from Canada.*—A typical illustration of how rights have figured in the financing of a well-known international corporation, is found in the history of Canadian Pacific Railway stock issues. In October, 1912, authority was obtained to increase the company's ordinary capital stock of from $200,-

000,000 to $260,000,000. The $60,000,000 of stock was issued to shareholders at 175 in January, 1913, in which month the stock was selling on the Toronto Stock Exchange from 240¼ to 271⅛, ex rights.

While it is impossible to estimate accurately the value of prospective new rights, and while there is no basis afforded in the record of rights offered by the Canadian Pacific Railway during the past ten years, the Wall Street Journal prepared the following interesting table in that connection:

Year	Rights	Dividends per cent	Rights and dividends per cent	Yield per cent on average price
1911	8.33	10.0	18.33	7.57
1910	....	9.5	9.50	4.29
1909	9.56	7.0	16.56	9.36
1908	7.69	7.0	14.69	9.17
1907	....	7.0	7.00	4.21
1906	11.69	6.0	17.69	9.94
1905	....	6.0	6.00	3.89
1904	5.62	6.0	11.62	9.45
1903	....	5.5	5.50	4.33
1902	4.75	5.0	9.75	7.46
Average, 10 years	4.76	6.9	11.66	6.96

On the basis of the average prices of these rights and the dividends paid over the indicated period, Canadian Pacific was an 11.66 per cent stock. In cash dividends above, the stock showed an average yield of 4.31 per cent on an average price of 160; a figure which compares with the yield on average price, over the same period, of two other stocks, then on a

10 per cent dividend basis, namely Union Pacific, 5.44 per cent, and Lehigh Valley, 6.50 per cent.

As indicated in this comparison, rights have played a much more important part in determining the market valuation of Canadian Pacific than of the other two. On the average price of 160, cash dividends and rights together yielded approximately 6.96 per cent.

The issue of rights by the Canadian Pacific Railway has invariably been the subject of criticism in Canada. In regard to the criticisms advanced respecting the issue in January, 1913, the Monetary Times, of Toronto, said:

> The general argument is against selling the stock at less than the prevailing market price, it being contended that many millions of dollars are sacrificed, and that these should properly go into the company's treasury. In other words, the directors are said to issue considerably more capital than would be necessary were they to sell it at the market price. The directors of the Canadian Pacific know better than any what they can and what they cannot do in the financial market. They recognize, too, than when one or more of the highest standing United States railroads tried to finance a new issue of stock on the market-price plan, bearing the hall-mark of "soundness," they failed. This being so, it is scarcely likely that they themselves will succeed.
>
> Regarding the sacrifice of the high market quotations reached by the Canadian Pacific Railway stock today, it is a moot question how much this enhanced valuation has been due to the recognition in the investor's mind of the very policy on the part of the management which in some quarters is deplored. It is a question also how that same valuation would stand the shock of any radical departure from that policy. To put it in other words, much of this high valu-

ation which the Canadian Pacific Railway is advised to preserve intact, and to reap the benefit, owes its existence to the knowledge by the public that the possession of shares entails certain rights— to obtain further shares at a price less than market. To this also attaches another consideration, namely, that original shareholders in the great Canadian transcontinental for years held on to a very dubious path, and that it is only fair, therefore, that they should receive some extra reward for their faith amid trying times.

10. *Regularity of dividends.*—If a corporation, in successive years, earns ten per cent, two per cent, six per cent and eighteen per cent, why should it not pay out in dividends the full amount earned each year? Why should the attempt be made to build up a surplus and to maintain a regular rate of dividends? Great confusion of thought has been manifested upon this subject.

Surplus consists of the excess of net assets over the par value of capital stock. No company has an actual surplus if its net assets are not worth more than the par value of its stock, unless the stock was issued for less than par in the first place. Hence it would appear that corporations whose stock continuously sells below par cannot well have an actual surplus, altho the majority of companies whose shares are sold continually at less than par upon the New York Stock Exchange show a surplus upon their books.

Corporations possessing adequate capital can have but one genuine and proper use for surplus, and that

is to stabilize dividends. The surplus is available for paying dividends to stockholders. Any other legitimate expenditure can be made from current earnings, or from the paid-in capital. Surplus, therefore, over and above dividend requirements, might as well be capitalized by a stock dividend. This brings to light an interesting fact. The piling up of unnecessary surplus is often used to hide a shortage of capital. Surplus is usually supposed to have been created out of earnings, and the principal reason for not capitalizing any large surplus is to obtain the psychological effect of appearing to have earned large profits. As already stated, if the capital stock is worth less than par, this impression of accumulated profits is fictitious. But the surplus, nevertheless, tho it may be nothing more than a book entry, gives an atmosphere of stability which improves the borrowing power of the corporation and perhaps has an effect upon the price of its stock in the market.

It is better for a corporation to pay a regular rate of dividend each year, gradually increasing the rate as profits increase, than to pay a highly fluctuating rate depending directly upon earnings from year to year. Investors in corporate securities desire steady income, and stability of market values. Regularity of dividends tends to accomplish both, tho market prices will always fluctuate with earnings, since earnings must ultimately go to stockholders in some form unless consumed by losses.

The credit of a corporation is improved by steady dividends, since they lend an air of permanency and certainty to the business. By the accumulation of a reasonable surplus, profits may be actively retained in the business, yet legally available for dividends in unprofitable years, when dividends could not otherwise be paid without impairing capital.

11. *Fixing the dividend rate.*—Granting that surplus is not accumulated for the purpose of meeting a shortage in capital, but solely for the purpose of stabilizing dividends, the rate of dividend may be determined by adding the actual earnings of the corporation over a period of years and dividing the total by the number of years covered. The result is the average annual earnings during the period, and when divided by the par value of the capital stock, gives the rate of dividend which could have been paid without impairing capital. The rate actually paid, however, should be somewhat less than the rate thus determined, in order that a run of exceptionally bad luck, or unforeseen difficulties, may not entirely wipe out the surplus. All profits above this dividend rate should go into surplus, and, when the earnings are less than the dividend, surplus may be drawn upon to pay the regular rate. In the case of new companies without established earning power, the most conservative practice is to retain all earnings as surplus until the surplus equals from five to ten per cent of the capital stock and then to begin paying small annual dividends of, say three or four per cent, which

may be gradually increased every few years as experience indicates.

Dividends upon cumulative preferred stock should usually be paid annually if earned, without regard to surplus, but with care not to impair capital. Indeed, surplus has no true function except to average dividend payments against earnings. The financial difficulties of our large industrial trusts during the first ten years of their existence arose mainly from the unsound policy of paying out liberal dividends, frequently more than had been actually earned. These dividends were often for the purpose of sustaining the market for the stocks, so that the underwriters and promoters might unload their holdings at profitable prices. It is interesting to note that the best of these companies, as soon as the insiders had unloaded their promotion securities, changed their dividend policy and began to accumulate a surplus for stabilizing future dividends.

The change of a dividend policy in order to strengthen surplus and the general position is illustrated by the experience of a Canadian bank, whose paid-in capital stock was $2,860,000. Its dividend record was as follows:

Year	Rate per cent	Dividend
1907	2½	$59,906
1908	2½	86,298
1909	2½	110,112
1910	2½	110,170
1911	5 and 6	121,410
1912	6	127,836

Year	Rate per cent	Dividend
1913	6	165,563
1914	6	170,297
1912—Stock bonus to shareholders		$186,518

At the end of 1915, the bank president frankly confessed that it would have been a better policy to have retained a portion of the money paid in dividends for the establishing of a reserve to increase the earning power of the bank and as a protection against losses. In providing for losses and paying dividends the bank had not been able to build up such a reserve. This, the president said, would have to be done before profits could be distributed.

In order to adjust affairs the directors proposed a reduction in the capital of 50 per cent or $1,430,000. From this amount it was proposed to set aside one-half, namely $715,000, in a reserve account—the balance to be used to write down bank premises, depreciation in assets, and to place a sufficient sum in a contingent account to provide for possible losses on unsecured loans.

If profits to shareholders had been delayed for several years, the president declared such action would not have been necessary. He stated further, that to go on without making an adjustment would necessitate the profit for a number of years being applied to building up a reserve, and in providing for a depreciation of assets, thus precluding payment of dividends. This would not be a sound policy from the shareholder's point of view as it would make the stock difficult to dispose of, except as a sacrifice.

From this proposed adjustment, the president said that the shares, on a par value of $50, should have a market value equal to that of the original share of a par value of $100, because:

> A reserve account will be established equal to 50 per cent of the paid-up capital of the bank, and after appropriating all debts which now appear to be of a doubtful nature, a sufficient sum will be placed in contingent account to provide for all emergencies. The business should be again on a dividend paying basis, and we shall have a clear field before us.

12. ***Real and fictitious surplus.***—Actual surplus is usually created out of net earnings from operation. Fictitious surplus may be created by a stroke of the accountant's pen, simply by writing up the value of assets or charging maintenance items to inventory accounts. In one recent case within the writer's knowledge a surplus account was increased one million dollars by writing up a fictitious increase in plant value, under orders from the board of directors.

It is impossible to pay out fictitious profits continuously in cash dividends, so resort is had to surplus, which may conceal a multitude of sins. When one contemplates the very small *cash* dividends which many of our large corporations have paid and the very large *surpluses* which their statements show, he is inclined to remark, as did the man who saw a hen get off a nest containing an ostrich egg, "I do not believe it." A certain large company near Cincinnati, for instance, continuously shows book profits running into the hundreds of thousands of dollars,

but always in surplus, never in cash. Its sales have not been increasing as fast as its loans, and its cash dividends, tho slight, have been paid by borrowed funds. Has it a real surplus? Certainly not.

Real surplus may be derived from:

1. Net earnings from operation
2. Premium from sale of securities above par
3. Premium on sale of capital assets above their book values
4. Gifts to the corporation, such as inheritances, insurance paid on the death of officers, or the turning back of shares to become treasury stock
5. Interest or dividends upon securities owned, bank balances, etc.

In Canada also, the value of real estate has not infrequently, and without justification, been written up by corporations. The value of a head office or branch premises has sometimes been written up on the strength of a supposed increase, generally in the value of property in the surrounding district. Comparison of balance sheets for various years will reveal this difference and other changes of interest.

At the same time, there are occasions when the writing up of real estate is quite legitimate. In December, 1911, for example, an important change was made in the treatment of bank premises account by the Bank of Montreal. This account had for years been represented by the comparatively insignificant sum of $600,000, notwithstanding the large expenditure recently incurred for bank buildings and for providing

suitable accommodation for the increasing business thruout the country. The directors had been frequently criticized for having charged the full amount of the cost under this head against the profits of the year, and it was suggested that they should alter their system to conform to that of other banks in the published statements. They, therefore, had a conservative valuation made of the property, which resulted in a total of $9,088,000; land $4,735,000, and buildings, $4,353,000. They took back less than half that amount, or $4,000,000, in order to represent more adequately that item in the balance sheet. To adjust bank premises, therefore, the sum of $3,400,000 was applied and the balance carried forward.

13. *Investment of surplus.*—Surplus is invested in the business in the same manner as original capital; in fact, is merged with it so as to be physically inseparable. That is why surplus is often nothing more than a book entry, a child of the imagination, a clever deceiver. If certain funds are segregated entirely, so as to be available only for certain purposes, as, for instance, depreciation or dividend reserves, they cease entirely to be surplus.

Any discussion concerning the investment of surplus is, therefore, superfluous, since the same principles apply to the investment of capital funds. Since, however, surplus is presumed to stabilize dividends, it should be noted that this may be accomplished only by maintaining increasingly ample working capital. Improved efficiency, capacity and earning power may

result from investing earnings, partly or wholly in permanently productive assets, but this does not protect the dividend rate against years of absolute loss, when the best concerns in many lines of business are unable to make profits. The variability of profits is the only true necessity for surplus, where the corporation is properly capitalized, and this explains why the big industrial companies maintain not only a large surplus, but also a large proportion of working or liquid capital.

14. *Value of surplus to the creditor.*—The fact should be noted that creditors are better protected by capitalizing surplus, thru stock dividends or otherwise, for the reason that dividends may be paid in any amount and at any time out of surplus, but not out of capital. As the surplus is invested in the property, bondholders naturally come to consider it as a protection to them, which, of course, it is not if withdrawn for dividends. As a matter of fact, a large book surplus, if fictitious, is a menace to creditors, since the payment of a special dividend from it may swamp the corporation and leave the creditors nothing but a ruined hulk. By this means stockholders may sometimes manipulate affairs so as actually to prefer themselves to creditors. Paying regular cash dividends out of fictitious earnings has the same result, but it is more gradual. Both methods impair capital at the expense of creditors.

Banks with large surpluses have similar opportunity for fraud or mismanagement. Of two banks hav-

ing similar resources and liabilities, one having $2,000,000 capital is safer than one having $1,000,000 capital and $1,000,000 surplus. Instead of favoring large surpluses for banks and other companies, it would be fairer if the law limited surplus to an amount which would adequately insure the stability of dividends over a brief period of years, and compelled the balance of earnings to be either paid out in cash dividends or capitalized by stock dividends. This would tend, at least, to eliminate some manipulation and a whole lot of artificial accounting and false impressions.

The banking corporations of Canada possess a somewhat exceptional record in the matter of reserves as well as an exceptional record of good banking practice. When Dean Joseph French Johnson made a report on the Canadian banking system for the National Monetary Commission of the United States, some years ago, he took the ground that Canada's banks had made the mistake of increasing their rest funds rather than their capital. He pointed out that in the 10 years following 1899, the paid-up capital of the banks had increased about 50 per cent, and that while the surplus was 50 per cent of the capital in 1899, it was 75 per cent of the capital 10 years later. In this report, Dean Johnson said:

> Sentiment seems to have had most to do with the increase of the rest fund. There is a popular notion, and the banks have done a good deal to create it, that a bank's solidity and prosperity are somehow measured by the size of its rest fund,

and the banks have engaged in unreasonable competition to bring their rests up to the highest possible amounts. Furthermore, bank directors and managers like to have the market prices of their stocks steadily climbing upward. If they divided part of their profits among stockholders in the form of a stock dividend, there has always been the fear that the market price of the stock in consequence would decline and the bank somehow be injured. Bank directors also take pride in the maintenance of a regular rate of dividend. If they can increase the rate and at the same time add a proper amount to their rest fund, well and good, but they shrink from increasing the capital stock at the expense of the dividend rate. For all these reasons the Canadian banks during the last prosperous decade have failed to make their capital account grow with their business.

Book surplus is distributed by: (a) Cash dividends; (b) Scrip dividends; (c) Stock dividends; (d) The creation of special reserves; (e) Charging off a certain amount to make good, losses which have impaired capital, or to squeeze the water out of original overcapitalization.

Of these, the first two actually reduce net assets by the amount paid. The stock dividend preserves assets as before, but capitalizes earnings. The last two usually confess fictitious surplus.

REVIEW

What does the income account contain?

Describe the different kinds of dividends and explain the circumstances under which each form is employed.

What object is pursued in maintaining regularity of dividends? How should the rate be determined in such cases?

Explain how a large surplus may be a disadvantage to creditors.

CHAPTER XV

PROMOTING THE NEW ENTERPRISE

1. *Work of the promoter.*—In the financial sense, a promoter is one who assembles the capital for a new business enterprise. Individual and partnership undertakings rarely require the services of a professional promoter, but corporate enterprises are frequently so large and so widely owned that their capital can be assembled only by trained professionals. Capital must frequently be drawn from many scattered investors, who are not acquainted with one another or with the business which it is proposed to develop. These parties have no mutual interests which bring them together in business. It is the function of the promoter to find a business opportunity that will admit of the profitable employment of capital and then to interest the owners of capital to invest in it. Any reader who may have attempted to raise funds for a new enterprise can appreciate the difficulties of this task and will understand the great judgment, experience and intellect required by the successful promoter.

Altho the forming of consolidations constitutes, in one sense, a new enterprise, the process is distinctly different from that of promoting a new and previously non-existent business. The forming of consolida-

tions will be discussed in a later chapter; it is our purpose here to set out briefly the general characteristics of promotion work, with particular reference to the new enterprise.

In the first place, it should be understood that the promoter is necessary and deserves to be well paid for his work. Some one possessing the requisite experience and skill must grasp the opportunity and present it in the proper manner to investors. The fact that dishonesty, swindling and foolish optimism pervade the field of promotion reflects less upon the promoter than upon the intelligence of the investing public, many of whom are totally unable to analyze a business proposition. The more speculative the enterprise, the fewer are the facts presented and the greater is the appeal to the imagination. The slippery gentlemen who make a business of selling blue-sky securities are unfortunately large in number, but there are honest and reputable promoters.

2. *Investigating the new opportunity.*—The business world is so full of opportunities that it is never difficult to find a good one. But it is not so easy to select from the many opportunities the one which will yield the quickest, greatest, and most certain profit with a minimum of capital and effort.

In order that investors may be induced to enter a new proposition, and that their capital yield the maximum earnings, every phase of the proposed undertaking should be thoroly investigated, even if based upon some reasonably assured monopoly right, such as a

patent or a special franchise. It is important that every advantage be taken in selecting a location, providing a suitable financial plan, and making an effective appeal for capital.

Many millions have been lost in attempting to capitalize inferior opportunities, by locating a new enterprise in the wrong place, or by investing capital funds unwisely. In most cases, these losses might have been avoided by thoro and efficient investigation. Many new companies have been wrecked because the financial plan did not accord with the needs of the business or the desires of investors. Other worthy ventures, possessing all the essentials of success, fail to secure the requisite capital because not properly presented to the investing public.

3. *What the investigation covers.*—When a cursory examination points out a good opportunity for profit, an exhaustive investigation should be made before the financial plan is prepared for presentation to investors. Some of the more important considerations may be briefly listed:

1. Extent and permanency of the demand for the product or service
2. Existing or potential competition
3. Size, growth and profits of other concerns in the same line
4. Capital investment required to establish a new concern of maximum efficiency
5. Effects of possible substitution, seasonal requirements or fluctuating demands for the product

6. Possible effect of hostile legislation
7. Costs of manufacture, amount and stability of earnings, with special reference to the cost of maintenance and improvements
8. Probability of securing honest and effiicent management
9. Location of the industry, with due regard to:

   Proximity to sources of raw materials and supplies
   Proximity to the market for finished products
   Cost of constructing or renting, and of equipping the plant
   The extent, cost and character of the labor supply
   Cost of power, light, heat and insurance
   Possibility of expansion
   Suitability of climate
   Adequacy of transportation service
   Proximity of banking, repairing and other supplementary services.

4. *Investigation should be thoro.*—If the proposition is based upon a patent, or other monopoly right, it is necessary, in addition, to investigate the validity and value of the protection thus afforded. The uncertainties of capitalizing patents, franchises and good-will have been discussed in another chapter. The validity of a patent cannot be finally determined before the courts have passed upon it, while a better idea may render the patent valueless any day. The

value of patents is ordinarily much greater to an old, established business than to a new concern, since the former is in better position to judge their practical value, put them into immediate use and resist infringements. This is well illustrated by the visible autographing device for which the Eastman Kodak Company is said to have paid three hundred thousand dollars. A new company might not realize half the return from this invention that the Eastman Company is able to obtain with its large business. If space permitted, the writer could cite from his own knowledge a dozen instances in which the capitalization of patents has totally ruined both the bank accounts and the dispositions of stockholders, who have paid more attention to the cleverness of the patent than to its commercial possibilities.

The estimates in each phase of the undertaking should be substantiated by men of experience and reputation in that particular field, and compared, when possible, with the actual results obtained in other similar enterprises. The estimated cost of buildings and equipment, for instance, may be checked by securing bids upon them. The cost of production may often be determined, under specified conditions, from the experience and records of other concerns. Usually the production costs of the new company are underestimated. Optimism and error in this respect, and in under-estimating capital requirements, may sell the stock, but ruin the stockholder. From the report of the Federal Trade Commission, it is quite safe to

conclude that not over ten per cent of our corporations have any accurate record of their production costs. How much more difficult must it be to estimate in advance the capital or production costs of a new and untried venture. Obviously, where patents, mining resources, and other similar elusive assets are concerned, the estimate must be based more upon imagination than upon fact.

5. *Perils of promotion.*—The reader must not be discouraged if a pessimistic attitude seems to pervade this Text whenever speculative securities are discussed. The pessimism is real, and will serve its true purpose if it convinces the reader of the tremendous risks which attend such stocks. It is aimed only to impress upon the reader the necessity for that keen perception, and careful discrimination, which even the best informed find it difficult to apply in analyzing corporate securities. At no point is this more important than in scrutinizing the facts or conclusions arrived at thru partisan investigation. Often the investigation turns out to be nothing more than a perfunctory estimate, based upon more or less accurate hearsay, and tinged with self interest.

To illustrate. A small company was incorporated in Erie, Pennsylvania, to manufacture condensed milk. One week before the plant was to open for operation, it was clearly demonstrated to the embryo promoter by an experienced business man that, in competition with the existing concerns, the new com-

pany would be losing two cents upon every case sold, even if it should succeed in finding a market for its product. The new plant went into the junk heap without ever turning a wheel.

A consolidation was formed, based upon an opportunity investigated by a professional promoter from New York City, who operated in connection with one of the largest and best known underwriting banks. The investigation purported to show that the new consolidation would control 80 per cent of the output of the country; that the profits of the then existing separate plants, would, if added together, pay interest and dividends exceeding six per cent upon the entire proposed capitalization; and that the earnings resulting from market control and economies of combination would still further enhance the income. Within a short time after the consolidation, it was found that only two plants out of the seven which had been combined, were earning actual cash profits, and that the combine had taken in a number of weak brothers while leaving some good live ones outside. The water in this capitalization drowned most of the stockholders.

A company was promoted to manufacture life boats, unquestionably the safest life boat ever designed, only to learn afterwards that the boats would not sell because they occupied too much deck space and were too expensive. In other words, the investigation had failed to disclose that life boats were not

made to save lives, but rather to meet the minimum legal requirements of the various countries. This was before the "safety-first" campaign.

Another notable example of this type of prospectus was that of a canning company with headquarters in western Canada. It was described by a critic, as "a curious document, voluminous, and in parts, luminous, but about as airy as anything placed upon the market for some time." The investor was assured that an annual dividend of 200 per cent was "a very moderate anticipation for a company organized on the sound basis this one is." The most notable omission from the prospectus was the cost of raw material. Estimated profits of 200 per cent were figured on the basis that the raw material would cost nothing. Obviously that is one of the mistakes which do not occur in well-regulated promotions.

6. *Preliminary financing.*—The path of the promoter is full of jolts. He wears no shock absorber except a smiling countenance, an atmosphere of prosperity, and unbounded external confidence in his undertaking. The investigation satisfactorily concluded, he then faces the difficulties of preliminary financing. The promoter is usually a free lance, working on his own account, and deriving his profit by selling the business to investors for more than it cost him. It is true, as in the case of some of the earlier combines, that the promoter is sometimes engaged at a stated compensation. But this plan is not frequently resorted to because it ties the hands of the

promoter so that he cannot deal to the best advantage with the various parties at interest, some of whom may be deeply prejudiced against those who have engaged his services. If he appears in the deal as a hired man, most of his prestige and independence are gone. For these reasons, the promoter, before he can finance an enterprise, must not only investigate it, but he must usually secure absolute control, and retain this control until the financial plan has been carried out and the project is put into operation.

7. *Procedure in obtaining options.*—In most cases, this control is obtained by options upon the various resources which are to be capitalized. The options are purchased as cheaply and for as long a term as possible. In some cases it is necessary for the promoter to buy outright some resource upon which options cannot be had. The purchase agreement usually calls for payment on easy terms, so that the promoter may finance the enterprise before completing payment. Where options are to be had for a nominal sum, the real investigation is made afterwards, but, where options are expensive, or properties are purchased outright, an exhaustive investigation is necessary before the option is taken or the seller is asked to guarantee his statements of condition and earnings.

If the promoter should fail to assemble the proposition carefully, he may find that others have discovered his plan and forestalled him. For this reason, the various parties who own the resources which

are to be capitalized, are dealt with individually by the promoter. Each is kept in ignorance, if possible, of the negotiations or transactions with others, in order to avoid dissensions and jealousies.

Usually the promoter must be prepared to finance his plan thru the early stages with his own capital, or with funds borrowed upon his personal credit. A thoro investigation often costs considerable, to say nothing of the value of the promoter's time. When the investigation has been completed and the financial plan is prepared, it becomes necessary to incorporate the new company, and this involves expense. Sometimes, as we shall see, several corporations must be formed, as, for instance, where a construction company is utilized for the purpose of financing initial construction work. The stock books and securities of the new company must be prepared, and legal advice engaged. All this involves expense.

8. *Prospectus.*—With the financial plan completed and the company incorporated, the next step is to present the proposition to the investing public in the most attractive form. Here again expense is involved in the preparation and mailing of literature, advertising, etc. A prospectus must always be prepared, outlining the proposition in a manner designed to secure the support of investors. In the case of new and untried propositions, the prospectus must usually be elaborate. In more substantial undertakings, such as combinations of established companies having a record of earnings, or based upon the pro-

duction of a standard product or service, or backed by men of recognized experience and financial standing, the flowers may often be omitted, but the wedding between capital and opportunity must nevertheless be held. The prospectus is a necessity in each case.

9. *Financing initial operations.*—Frequently the proposition is such that initial operations must be financed before an effective appeal can be made to investors. A few tangible results, or a little tangible property subject to inspection, especially in highly speculative enterprise, appeals far more powerfully than an enterprise which exists only on paper. For this reason, the promoter and his associates, when financing an entirely new enterprise, often find it necessary to advance funds personally. Ordinarily this is done by issuing to the promoter all the securities of the new company in exchange for the properties, patents, or other resources which are to compose its assets. The promoter will then finance the enterprise personally, or with the assistance of borrowed funds, until enough of a tangible nature has been done to enable him to market the securities at a profit.

Usually enough securities are left with the corporation, or turned back to it as treasury stock, to enable the company to secure working capital and pay off any balance which may fall due upon the purchase price of its properties. This process, it should be remembered, is only followed in the case of highly speculative enterprises, where something tangible

must be had to talk about before the investing public is approached.

10. *Financial plan.*—The promoter obtains the securities of the company in payment for the property which he transfers to it. The speculative public likes low priced stocks. To meet this demand, and to retain some stock for himself, the promoter is usually compelled to overcapitalize the new company. He may then offer low priced securities to obtain the necessary capital and still retain a block of stock for his promotion profits.

Bonds will probably be issued if the assets are such as to afford good security, the object being to sell these bonds, perhaps at a discount, or accompanied by a stock bonus, to secure the bulk of the actual money needed. If the enterprise is an industrial undertaking, not affording good security for bonds, preferred stock will probably be issued, to be offered in the market at a discount, or accompanied by a bonus of common stock. Those who sell their property to the new company will be induced, if possible, to accept bonds or preferred stock in part or full payment, and to this extent the necessity is removed of finding an outside market for the securities and perhaps of borrowing for initial financing.

The promoter must be careful to see that adequate new capital is provided, else the plan may fall thru completely at a critical stage from lack of funds. If enough cannot be borrowed directly, upon his own credit and that of the new company, to finance it until

the securities have been sold, it may be necessary to employ an intermediary corporation, often known as a construction company, having capital of its own.

The object of this construction company is to supplement the credit of the new corporation, so that funds may be borrowed for construction purposes. As a rule, the construction company can accomplish this purpose only where the property to be constructed affords reasonably good security for bonds. The capital of the construction company itself, supplemented by the bonding power of the property under construction, is made the basis of temporary loans.

11. *Construction company.*—If, for instance, a railway is to be constructed and it is desired to put a portion of the road into operation before appealing to the public for funds, a construction company will be organized which will make a contract with the railway company to construct a certain portion of its road and to receive in payment the bonds of the railway company at a certain rate per mile, together with all or part of the capital stock of the railway company. The bonds and stocks will be issued in payment as the road is constructed. It is expected that the bonds will cover the actual cost of production, the capital stock being looked upon as promotion profits. The construction company expects, when the road has been placed in operation, to market the bonds for enough to pay back the amount expended in construction. But the construction must go forward and be paid for before the bonds are sold, and the construc-

tion company, therefore, must borrow to meet the cost of construction.

This it does by arranging with local banks or others to advance funds at a certain rate per mile as the road is completed. The construction company gives its own notes secured by the deposit of the railway company bonds. The bankers may also exact a bonus in stock to compensate them for the risk assumed. When the road has been constructed and placed in operation, the bonds are marketed, the bankers are paid off out of the proceeds, and the construction company is wound up by the distribution of its capital and profits to the promoter and his associates who formed it. The railroad company itself has retained certain securities which are now sold to obtain working capital and to complete the construction and equipment of the road.

12. *Promoter and the corporation.*—The promoter has a peculiar relation to the corporation which he is promoting. The corporation is not bound by his contracts unless it specifically ratifies them or accepts benefits under them. A corporation is not bound to pay the promoter, except for the necessary expense involved in the processes of incorporation. This includes nothing for investigation, sale of securities, or promoter's services. That is why the promoter must usually get his pay by watering the stock and selling it to the public at somewhat inflated prices.

It is illegal for the promoter to make secret profits

at the expense of the corporation, altho reasonable profits, or high prices paid by the corporation with its eyes wide open, are permitted.

As a rule, promoters are not overpaid, since they must possess great skill, assume unusual risks, and stake their reputations on single ventures. There are very few professional promoters of high standing. The success of these men has been largely due to the active cooperation of great financiers. Such financial backing is a big element in the promoter's success.

13. *Local promoters.*—There are several other classes of real promoters and untold millions of would-be promoters. Local lawyers and bankers attempt from time to time to secure support for local enterprises. Their success depends upon their financial ability and standing in the community. Space is too limited to describe here the work of the local promoter. They are usually compelled to turn to the professionals, or to the financiers of the larger cities, for assistance in the promotion of any enterprise of more than local extent. Such assistance is not usually granted unless the control of the new enterprise, and the bulk of the profits from its promotion, are turned over to the financiers. The local man becomes a figurehead in such cases, with perhaps a small fee, or a position in the new company, to compensate him for his efforts.

14. *Incorporated promoters.*—The most modern type of promoter is the engineering firm, such as the Stone and Webster Corporation of Boston. Firms

of this nature entered the business of promotion in the endeavor to find regular employment for their large and expensive staffs of experts. They are much better able to investigate a proposition thoroly than is the individual promoter or engineer. They are able not only to investigate, but to supervise the construction and the early operation of enterprises which they promote. Such firms usually have a large capital of their own and possess the confidence of the banking fraternity. They are able, because of their own capital and the support of the bankers, adequately to finance enterprises which the individual promoter probably could not handle. Professional firms of this kind constitute the logical type of promoter for such substantial and technical undertakings as street railways, water, gas, light and power companies, and other public utilities.

They are not found in the field of speculative promotion for the reason that they cannot afford to stake their reputations in such enterprises. Aside from public utilities, engineering firms do not engage extensively in promotion work because of the uncertainties and risks involved. The individual promoter, backed perhaps by a small syndicate of rich individuals or speculative bankers, will probably always continue to promote mining, industrial and other speculative enterprises.

REVIEW

What is the function of the promoter in the modern organization of business?

In investigating proposed enterprises what points is it desirable to cover?

What precautions may be taken to test the accuracy of the results of such investigations? Illustrate from your own experiences, if possible, how failure to take such precautions leads to disaster.

Why must the promoter use his own or borrowed capital before the enterprise is launched?

How does he secure himself for his advances and services?

Explain the role of the construction company in promoting new enterprises.

Describe different types of promoters.

CHAPTER XVI

PROMOTING CONSOLIDATIONS

1. *Economic advantages of consolidation.*—Competitors in any given line of business frequently find it advantageous to consolidate their interests for the purpose of effecting economies of production or distribution, or to control the market. The principal economies of consolidation may be summarized as follows:

1. Price control and the elimination of competition
2. Elimination of cross-freights
3. Elimination of duplicated advertising and selling expense
4. Stronger position in dealing with organized labor
5. Saving by large-scale purchase of materials and supplies
6. Saving by concentrating office and executive work
7. Saving in costs by the specialization and integration of production
8. Saving due to a general use of patents and special processes
9. The standardization of products.

For a full explanation of these economies of combination, and of the history and nature of the various types of organization, reference is made to the Modern Business Text on "Organization and Control." Discussion of the taxation and regulation of corporations by the government and of their effects upon the formation of consolidations is omitted also from this book because of the special treatment given to this subject in the Text on "Business and the Government." The object of this chapter is to present the financial considerations which determine the capitalization of combinations and the methods of promoting them.

2. *Methods of consolidation.*—Competition between independent companies may be eliminated by:

1. Pooling their products or markets
2. Voting trustees holding controlling interests
3. Merger, thru the purchase of physical assets of one or more companies by another, or thru the purchase by one of the capital stock of others
4. The holding company
5. The fixing of prices or trade customs by gentlemen's agreement, usually thru the medium of the trade association.

Pools and trusts, in so far as they restrain trade or tend toward monopoly, have been long since declared illegal. The merger of assets, and the control of one company by another thru the purchase of outstanding capital stock, are processes possessing cumbersome restrictions. It often becomes necessary to

secure an amendment to the charter, or the consent of a large majority of the stockholders, before such physical mergers may be effected. The financing of a merger is frequently difficult, because of the mutual jealousies and distrusts which accompany negotiations between competitors. Frequently the stockholders of the purchased company will not take the securities of the purchasing company, which necessitates the sale of stock in the open market under adverse circumstances. Individual producing companies are seldom large enough to swallow competitors whole in this manner, and even when they are, the process is necessarily difficult and gradual. Mergers are, therefore, infrequent as a method of combination.

The holding company, as we shall see, overcomes most of these objections and enables large combinations to be effected with comparative ease, especially when the competing interests favor consolidation. The decisions of the Federal Court in the suits against the Standard Oil Company and the American Tobacco Company, however, struck directly at the holding company as an instrument of combination. When the purpose of the holding company is directly to restrain trade, establish monopoly, or substantially impair competition, as is undoubtedly the case in many instances, there is great doubt as to its legality under present Federal and state laws, altho the laws of 1914 concerning trusts and establishing the Federal Trade Commission are not retroactive. For this reason, many competing companies avoid the semblance

of combination and yet endeavor to obtain some of its benefits thru the formation of trade associations. These have no binding effect beyond the common understanding and action of members.

3. *Trade associations.*—Trade associations, altho established for the ostensible purpose of exchanging useful information, improving the industry and encouraging the elimination of trade abuses, sometimes cover up trade agreements which would, if expressed openly in writing, render the member companies and their officers subject to indictment under the Federal Anti-Trust Laws. To avoid any appearance of illegal agreement, nothing is ever openly said or recorded that would indicate concerted action by agreement. Price and trade practices are discussed in private meetings, and common action is taken, based upon gentlemen's understanding, which is usually observed as closely as a written agreement.

After the subject has been discussed in meeting, various members will state what they intend to do. At the close of a conference, for instance, one member will say, "It is my intention to raise prices to such and such a figure and hold them there until the first of December." Other members will express the same intention, and it is fully understood that prices have thus been fixed. And yet no agreement has been entered into. Legally the members have merely expressed individual intentions and have not bound themselves to any concerted action.

4. *Holding company.*—The holding company is

a corporation whose principal object is to acquire and hold the securities of other companies for the purpose of securing the economies and profits of combination. Companies which hold the securities of other corporations merely for investment, and not primarily for control, may more properly be called investment companies. Savings banks, finance companies, and the investment companies of England are in this class. The prime purpose of such investment companies is to secure profits thru the dividends and increasing values of the securities held. Savings banks and insurance companies best illustrate this type.

Finance companies are well illustrated in this country by the Electrical Securities Corporation and the Electric Bond and Share Company, the stocks of which are owned by the General Electric Company. It is the object of these two corporations to assist in the financing of new companies which purchase equipment from the General Electric Company. It is not their aim to effect a consolidation of competing interests, but rather to get new business for the General Electric Company and incidentally obtain the underwriting profits from new companies which they finance.

5. *Advantages of the holding company.*—The holding company has distinct advantages over any other form of combination. It may be chartered in New Jersey, Maine, or some other state where extensive corporate powers may be had at minimum

cost. Until New Jersey passed an act in 1889 permitting corporations to be chartered with the specific power to hold stocks of other companies, none of the states permitted this form of combination. Since then, numerous states have, by general law, authorized holding companies to be incorporated. Corporate charter fees and taxes look very attractive to the state treasuries.

The holding company has numerous advantages in affecting combinations. As a separate corporation, independent of competing interests, it is in a position to deal with each of them upon a business-like basis, free from the jealousies and suspicions which exist between competitors. It is often able to secure financial support which the individual competitors could not obtain. It secures also the advantages of combination without the necessity of direct dealing between competing interests.

Altho examples are not lacking of holding companies or of combinations which have been formed by the mutual agreement of competitors, such promotions are distinctly rare. It is an established principle in the promotion of consolidations that the various units must be dealt with individually. In the smaller industrial combinations, it is customary, in the initial negotiation, that the individual companies should not be permitted to know the basis upon which their competitors are entering. The promoters must be financially strong, in this case, as some of the more powerful companies may demand cash, while the

weaker ones are willing to accept securities from the new combination in exchange for their property. The dealings of the promoters, of course, are with the controlling stockholders of the competing companies. As a rule, the minority stockholders will follow the lead of those who control, knowing full well that the holding company can obtain control without their shares.

6. *Procedure in forming holding companies.*— There are two general methods of promoting consolidations:

(a) A bargain is driven with the stockholders of each company separately, by which the controlling interests are purchased with cash, bonds or stock of the new company, upon an agreed basis.

(b) The basis of consolidation is fixed by the promoter, after conference with the leading interests to be combined, this basis laying down a general plan for determining the value of the various kinds of assets, and of paying for same in cash or securities of the holding company.

The first plan is used only where the feeling between the competing interests is extremely bitter and competition is relentless and unfair. In such cases, it is difficult to lay down any mutually satisfactory basis of valuation, or even to get together a committee that will work in harmony to determine such a basis. Furthermore, the promoters realize that under such conditions profits have been unduly depressed by relentless competition, many are anxious

to sell, and controlling interests may be purchased thru individual negotiations at low prices. This affords the promoters opportunity for a greater profit than is possible when the owners of the various plants know how the holding company's securities are being distributed.

The second plan is more often used, and is perhaps more fair than the first. It requires a certain amount of cooperation or friendly negotiation between representatives of competing companies and a great deal of confidence in those who are handling the promotion. Sometimes a promotion is begun upon the first plan and finished upon the second. The second plan illustrates better than the first the true basis of consolidation, in which an attempt is made to apportion fairly the securities of the holding company to the interests being combined upon the basis of actual assets bought.

7. *Investigation by the promoter.*—The promoter is interested in ascertaining the actual value of the various companies which he is attempting to combine. This value is expressed mainly in the earning power. The earnings depend upon two factors, the physical properties of the companies and the efficiency of their management. Good-will is nothing but the capitalized value of past successful management.

The promoter first approaches those who control each company for a statement of the assets and liabilities of the concern, and the income statements for a number of years back. It is particularly important

that the growth in actual cash dividends be compared with the growth in gross sales, plant assets and capitalization. If the capitalization and outstanding obligations of the company have increased as rapidly as its business, it is probable that very little has been reinvested in the business out of profits. If cash dividends have grown faster than gross sales, with business increasing, a reduced cost of production and increasing efficiency of operation are indicated. If, in connection with this latter condition, the increased plant capacity has been made out of earnings, in addition to cash dividends, it is apparent that the company is highly successful in competition and will make a valuable member of the combine. This merely indicates the nature of the preliminary considerations to be investigated.

Unless a basis of payment for the various classes of assets has been agreed upon by those in control of the competing companies, it becomes necessary for the promoter to obtain an option upon the controlling capital stock in each, in order that no one or more of the companies may withdraw when the final basis of consolidation becomes known. When the various companies are dealt with independently, these options are almost always sought by the promoter. The price named in the option is the result of a bargain arrived at between the promoter and those who control the company, and is usually based upon some such preliminary statement and analysis as that above indicated. Not until the basis of consolidation has be-

come known, and the option definitely accepted by the promoters, will the plant owners permit outside appraisers or certified accountants to examine their affairs. This explains why many promotions are undertaken upon the first basis and are finished upon the second. The promoter, with his options, becomes all powerful and possesses absolute control of the situation, provided he has the necessary financial backing to take up the options.

With these options in hand, the promoter's next step is to draw the parties together in conference, and, by showing them that they will fare better under the second plan, to get them to agree upon a mutual basis of consolidation by which they take securities instead of cash for their properties. If the promoter avails himself of the right to purchase the various plants upon option, he will require a great deal of cash. By converting the combination from the option basis to the mutual valuation basis, to be settled in stocks and bonds of the holding company, less cash will be required, and those who have been previously associated with the business will be actively retained in it. If a basis of consolidation has been agreed upon which calls for a valuation of assets, the appraisers and expert accountants are next called in to make detailed reports and to complete the investigation which is necessary to determine the price to be paid for each plant.

8. *Basis of consolidation.*—If the promoter purchases the various plants upon option, there is no ba-

sis, except the arbitrary price agreed upon in each case. If, however, the owners submit to a valuation of their properties, as they usually do, it becomes necessary to adopt a definite basis for evaluating each class of asset and paying for it.

The promoter, in securing his option or obtaining mutual consent to a basis of consolidation, has used every means in his power to convince the competing companies of the desirability and necessity of combining. To the stronger concerns, he pictures the great economies to be had in production, market control and the elimination of ruthless and often senseless competition. Each large stockholder is flattered by hints that the combine will need a big man of his caliber for president, treasurer, manager or purchasing agent. The writer remembers one case in which there were six different men who expected to be president of the new combine, each, of course, keeping it a secret from the others. As many more expected to be purchasing agent, a position which is frequently the best paying job in the combine. It was naturally much easier for the promoter to explain afterwards to the disappointed ones why his plans had miscarried than to lose their support beforehand.

To the weaker concerns, the promoter explains the tremendous strength of the new combine and the impossibility of any small concerns competing with it. Once it became apparent that terms had been made with Mr. Carnegie to sell his interests to the United States Steel Company, there was little difficulty in in-

ducing his competitors to enter. It is frequently necessary, as in this case, for the promoter to offer exceptionally strong inducements to the more powerful competitors and to make up the loss by penalizing the weaker ones. Those who are afraid, and yet feel the necessity of joining the combine, are naturally negotiating at a disadvantage.

It is customary, in arriving at a basis of payment, to take an actual appraisement, upon a uniform basis, of the physical assets, all differences of opinion being referred to a committee for adjustment. This committee is often dominated by the promoter. Tangible assets are usually settled for in cash, bonds or preferred stock of the holding company. Intangible assets, such as good-will, are usually paid for in common stock. The value of good-will is generally determined by capitalizing over a period of years the average earning power of the company. Mr. Carnegie, for instance, has said that any company is worth the replacement value of its physical assets, plus the profits, or minus the losses, of the three years' business just preceding.

It is customary for those who are selling to guarantee such items as accounts receivable, and for the holding company to withhold a portion of the purchase price, in the form of securities, until all such guarantees and other contingent matters have been adjusted.

Usually the active managers of the various units are retained in the employ of the corporation. It is

customary for the holding company, when the actual basis of combination has been determined, to buy in all the outstanding capital stock of the subsidiary corporations in exchange for the securities of the holding company.

9. *Promoters' profits.*—The promoters derive their profits in various ways. In a few cases, as in one of the earlier steel combines, the promoter is engaged outright at a stipulated compensation, guaranteed by the various interests who desire to consolidate. This, however, is very rare, and the promoter usually gets his profits out of the preferred and common stock that remains after the owners of the individual companies have been paid at the agreed rate.

REVIEW

Enumerate the advantages which are claimed for the consolidation of existing enterprises.

Describe the different ways by which it has been sought to eliminate competition and discuss the methods and efficiency of each.

Distinguish between investment companies and holding companies, and discuss the advantages of the latter in forming consolidations.

What is the usual procedure in bringing about a consolidation, and why are those which are begun by one method frequently closed by the other?

What is the nature of the facts which the promoter requires in his investigation of a consolidation proposition and how does he interpret them?

By what different motives does the promoter assure the assent of the stronger and of the weaker competitors to the proposed combination?

CHAPTER XVII

SELLING STOCKS AND BONDS

1. *Methods of selling securities.*—There are four general methods of selling corporate securities:

1. Compulsory or preferential offering to present stockholders
2. Thru underwriters and the Stock Exchange to investors
3. Thru established bond or brokerage houses to investors
4. Direct sale by the corporation to investors.

The first method needs little comment. If the stock of a corporation is closely held, the present stockholders will probably contribute new capital when required, or, if the shares are widely held, the present stockholders may be given the opportunity of subscribing upon some preferential basis. This has the effect of selling the shares and at the same time distributing a profit to shareholders. The shareholders of the Pennsylvania Railroad, for instance, had the opportunity to subscribe to additional shares at 120 when the stock was selling thirty or forty points higher. A stock dividend, also, is substantially a forced subscription to additional capital stock, and illustrates the inside distribution of shares.

The second and third methods are briefly described

in this chapter. The established machinery of the security market and the principal channels thru which corporate securities reach the ultimate investor are more fully considered in the Modern Business Texts on "The Exchanges and Speculation" and "Investment."

The fourth method will be illustrated in this chapter and also in the Text on "Investment." It is employed, as a rule, only to market issues which are too small or speculative to be sold by any of the other methods. It must not be thought, however, that all the extremely speculative securities are marketed direct, since many large speculative issues, such as copper stocks and industrials, are sold upon the exchanges.

2. *Machinery of the security market.*—The savings of the people constitute a continuous fund available for investment. Since most of our industrial wealth is controlled by corporations, savings necessarily create a large and growing demand for corporate securities. The demand for securities may come from the investor direct or thru institutions such as savings banks and insurance companies, to which he has intrusted his savings. The demand, furthermore, is for all kinds of securities, ranging from the most speculative mining stocks to the safest kind of government and railroad bonds. The volume of such investment in corporate securities is enormous, amounting in the United States to several billions of dollars each year.

Supplementing this investment demand and as a natural result of it, there is also a very large speculative demand by those who desire to profit from the fluctuations of the market. These speculative sales are much greater in amount than the investment transactions. They tend to steady the market by foreshadowing the rise and fall of security prices, except in a panic, when speculative holdings are dumped upon the market and add to the demoralization of prices.

Corporations which have securities to sell are not in touch with investors. Consequently, a class of traders has sprung up to bring supply and demand together. They have established markets known as stock exchanges where bonds may be bought and sold.

Omitting the lawyers, promoters, accountants, engineers and other necessary evils attending a new promotion and confining our description to the marketing machinery, we find four principal elements:

(a) The brokers who execute buying and selling orders for customers, whether for investment or speculation.

(b) The stock exchanges, which are voluntary associations of brokers, organized to conduct a market place for the purchase and sale of securities, a place where those who are members may meet and transact business.

(c) Investment bankers who purchase, after investigation, large blocks of securities which are then sold retail to investors who compose their clientele.

(d) Underwriting bankers, composed of banking houses which purchase from corporations, or agree to sell for them, whole issues of securities, which the corporations have not the facilities of marketing direct. The securities are sold thru members of the syndicate to their clientele, or thru brokers upon the stock exchange.

Perhaps to this list should be added the state and national banks, and the chartered banks of Canada which assist speculation in securities by making loans upon them as collateral. Were it not for the assistance of these banks, the operations of brokers would be greatly curtailed, for they would then have to depend upon their own capital, or that of their customers, and thus practically eliminate margin trading. The process of dealing on margin consists simply in purchasing securities with borrowed funds, the securities themselves being pledged as collateral to the loan. The borrower invests some of his own funds, but deposits all the securities as collateral to the balance borrowed, thus maintaining an adequate margin of safety to the lender. The margin must be made good if the security prices decline, or the collateral will be sold out by the bank to pay the loan.

3. *Investment prospectus.*—Whatever the method of marketing may be, the security must be presented ultimately in such a way as to induce investors to buy it. Unless sold to inside interests, who are thoroly acquainted with the affairs of the company, a pro-

spectus is needed to explain to the investor the nature and purpose of the issue.

The prospectus is supposed to contain such information as will enable the investor to judge the merits of the proposition. It must be drawn with particular reference to the nature of the security and the type of investor to be reached. If the issue is a high class stock or bond, strictly in the investment class, the prospectus will naturally be conservative. Facts will be presented in a brief dignified manner which appeals to conservative investors.

If the issue announced is that of a new and highly speculative venture, facts may be dispensed with in favor of picturesque language, clever inferences and talk of big profits.

The investment prospectus is a brief document, prepared in a neat but simple style, without adornment or apparent exaggeration. The attempt is made to present concisely the essential facts relating to:

1. Description of the stock or bond being marketed
2. Security for the issue
3. The purposes of the issue
4. Extent and nature of the company's business
5. Description of the company's properties
6. Brief history of the company and its growth
7. Statement of the company's earnings several years back.

When the company is widely and favorably known,

the prospectus may not even present all the items above listed. On the other hand, if the offering is made at a time when investment funds are scarce or the company is not favorably known, the prospectus may elaborate, and perhaps occupy four or five pages of a neatly printed pamphlet or folder. On page 277 is a typical investment prospectus, such as is issued by well-known investment bankers to their clientele, announcing the sale of an investment security:

4. *Advantages of having securities underwritten.* —To underwrite means to insure. In the security market, underwriters are bankers who insure to the corporation that the entire issue will be sold. Underwriting is fully described in the Text on "Organization and Control."

The corporation obviously benefits from the underwriting of its securities, in most cases, for the following reasons:

1. It has not the skill, organization nor clientele which will enable it to sell securities quickly, cheaply and to the best advantage
2. The certainty of having the funds in hand at the proper time is valuable
3. The credit of the corporation may be impaired if efforts to sell its own securities fail.

There are also distinct advantages to the investor in purchasing from investment bankers. These bankers will not underwrite an issue, nor recommend it to their clientele, unless a thoro and expert investigation has been made. The investor feels that the reputa-

$9,000,000

THE CUDAHY PACKING COMPANY

FIRST MORTGAGE 5% SINKING FUND GOLD BONDS

Dated December 1, 1916 Due December 1, 1946

Callable at 102½ and accrued interest on any interest date

ILLINOIS TRUST AND SAVINGS BANK AND WILLIAM H. HENKLE, Trustees

Authorized,	$12,000,000
Outstanding (now offered),	9,000,000

The Cudahy Packing Company, originally organized in 1887, is one of the largest packing house concerns in the country, having plants in South Omaha, Kansas City, Sioux City, Wichita, Memphis, East Chicago, Indiana, and Los Angeles, and distributing branch houses in 92 of the principal cities of the United States. The business has been successfully and profitably operated for 28 years.

From a letter of Mr. E. A. Cudahy, President of the Company, we summarize as follows:

Direct first mortgage on real estate, plants, branch houses and rolling stock, valued at $12,804,000.

Net quick assets of Company (exclusive of real estate, plants, branch houses and rolling stock), $15,682,000.

Total net assets $29,159,000, or $20,000,000 in excess of these bonds.

Sinking Fund $250,000 per annum, first payment December 1, 1917.

Net earnings for year ending October 28, 1916, $3,353,118, or more than 7 times total interest on this issue.

Average annual net earnings for last 5 fiscal years more than 3½ times interest on this issue.

Price 98¼ and interest, yielding more than 5.05%

WE RECOMMEND THESE BONDS FOR INVESTMENT

Temporary negotiable receipts will be delivered exchangeable for definitive bonds, when, as and if issued and received by us.

All legal matters relating to this issue will be passed upon by Messrs. Herrick, Smith, Donald & Farley of Boston, and by Messrs. Defrees, Buckingham and Eaton of Chicago, and the books of the Company have been audited in our behalf by Messrs. Price, Waterhouse & Company.

LEE, HIGGINSON & CO.

43, Exchange Place

BOSTON **New York** **CHICAGO**

PRESCOTT L. LYON

Pittsburgh Representative

808 Commonwealth Building **Telephone 3498 Court**

The statements contained herein are not guaranteed, but are based upon information and advice which we believe to be accurate and reliable, and upon which we have acted in purchasing these securities.

This advertisement appears as a matter of record only, all of the above bonds having been sold

tion of the banker is a safeguard to him, since this reputation is largely founded upon past good judgment in selecting securities. The investor himself is not in position to make any searching inquiry which perhaps requires the exhaustive scrutiny of legal, engineering and financial experts.

Among the comparatively few large underwriting houses in the United States, are J. P. Morgan and Company, Speyer and Company, Kuhn, Loeb and Company, Blair and Company. Some of them are not only underwriters, but also engage indirectly in the business of promotion. In the formation of the Consolidated Lithograph Company, for instance, altho Mr. Grant Hugh Brown acted individually as promoter, it was well understood that he represented Kuhn, Loeb and Company, even tho their name did not appear. These large underwriting banking houses are not commercial banks of deposit and discount; they are primarily engaged in the purchase and sale of securities.

As underwriters, they purchase entire issues from large corporations, a number of them perhaps combining in a syndicate to share the risks and profits. The securities are then marketed thru the members of the syndicate, usually over the Stock Exchange. In the case of high grade bonds, the large investment banking houses may share in the underwriting. These bond houses should not be confused with the strictly underwriting bankers, altho closely allied with them.

Those who underwrite the securities of large corporations must necessarily command great capital in order to carry and to market large issues. Considerable risk is involved, for if they underwrite more securities than the public will absorb, as happened in the so-called Rich Man's Panic of 1903, or at a higher price than the public is willing to pay, they may sustain very heavy losses. For this reason, such concerns cooperate closely, and divide the proceeds of the underwriting with one another thru syndicates, each member of the syndicate participating in the underwriting and taking his share of the risk and profits.

Altho syndicates and underwriting are not modern devices, the underwriting of large issues of corporate securities is a modern development. The modern underwriting bankers are scarcely underwriters at all, since they usually purchase their securities outright instead of merely insuring their sale. They are able to do this because they possess great financial power, broad experience, skill in analyzing securities, and a wide clientele to which they may look with some certainty for a market.

5. *Types of underwriting.*—The modern underwriter is a jobber in securities. Five types of underwriting syndicates may be discerned:

(a) The old original type, in which the corporation sold the securities and the syndicate merely agreed to take, at a stated price, any portion of the issue which the corporation failed to sell. For this insurance they received a commission upon the securities

sold by the corporation in addition to obtaining the remaining securities at a low price. This illustrates a pure underwriting, which is no longer customary, because the syndicate has so much better facilities than the corporation for selling securities.

(b) The following type can hardly be called an underwriting at all, since the syndicate takes little or no risk. It consists in turning over to the syndicate at a fixed price the securities to be sold, the syndicate paying the corporation as fast as the securities are sold and turning back to it any unsold portion of the issue. Naturally under this form the commissions are light because the corporation takes the risk, and for the same reason this type is not much favored.

(c) A different type of syndicate arises when one house which has underwritten, or is about to underwrite an issue of securities calls upon other houses to take portions of the issue at attractive prices. In this type, the original underwriter makes the contract with the corporation and perhaps manages the early marketing operations for the syndicate, but is protected in its contract by the participation of the other members, who share in the profits and losses of the operation and take up their shares of any portion of the securities remaining unsold. The underwriting managers usually get a stated commission in addition to the profits upon their share of the underwriting.

(d) A further type differs from that just described in that the syndicate as a whole joins in the contract with the corporation whose securities are being under-

written and therefore the members share among themselves the special profits which would otherwise go to the principal underwriter. An individual of wide experience is always chosen as manager of the syndicate to act on behalf of all the members in making contracts and marketing securities.

(e) In the most modern type, the syndicate may be organized as in (c) and (d) above, but the marketing of the security, instead of being concentrated in one house, or in the hands of the manager, is apportioned among all the members of the syndicate, and perhaps by them to still other outside houses, in order to take advantage of the wide powers of distribution which the combined clientele of the syndicate members affords. In this form, however, it is customary to retain certain restrictions upon the sale, in the discretion of the syndicate manager, to secure harmony of action and avoid flooding the market.

The distinguishing features of modern syndicate operations are the remarkable accuracy with which they judge the market and the value of the new security, the great cooperation which exists between the leading houses, and the control which these houses exert over the management of the corporations whose securities they underwrite.

6. *Syndicate operations.*—Having taken over the securities of the corporation at a stated price, it is now the duty of the syndicate, under the direction of its manager, to market them to the best advantage. Cash may have been paid out of the capital of the

syndicate for the issue, or partly obtained by bank loans, secured by the stocks or bonds as collateral. Or the corporation may be paid gradually, thus giving the syndicate opportunity to sell the securities without tying up much capital.

If the issue consists of bonds, the large bond houses, who are associated with the underwriters, may participate in the underwriting. Most corporate bonds sold in the United States are marketed by them. They have long lists of customers who are regular buyers of bonds, and who depend upon the bond house for advice and protection. Owing to their rather steady prices, speculation in bonds is not great, and the investment demand thru the exchanges is uncertain. The underwriters, therefore, turn eagerly to the investment bankers.

7. *Handling stock issues.*—If it is a stock issue which is being underwritten, the stock exchange market is relied upon mainly. In this case, it becomes necessary for the syndicate manager to arouse speculation in his stock upon the exchange. The first step is to have the stock listed, so that it will appear in the daily quotations of the exchange, which are published thruout the United States. It is said that the New York Stock Exchange receives more free advertising than any other privately-owned profit-making institution in the world. The underwriters also see that their associates and customers are informed of the issue and that a suitable prospectus is available for distribution.

The speculators, discounting the fact that the underwriting syndicate will be under the necessity of sustaining the price of the stock until it has all been sold, will probably purchase heavily in the beginning to take advantage of the probable rise in price. It will be arranged with the bank to accept the stock as collateral for loans. As the stock becomes better known, it will gradually be absorbed by permanent investors who have faith in the future of the company. The length of time required by the syndicate to market the issue depends somewhat upon its attractiveness, the condition of the market, and the skill with which the market is pushed and manipulated. Speculators themselves absorb very little of the stock, since they buy only on the expectation of selling again soon, but their activities are a great advertisement for it and thru their stimulating activities the actual investor becomes interested.

When the whole issue has been disposed of, the syndicate will be dissolved, and the stock will probably be left to its fate in the market. The investment demand now takes the place of the syndicate operations in sustaining quotations.

8. *Sale of bonds.*—Altho bonds are listed and sold upon the stock exchanges of the United States and Canada, their principal market is thru the large investment banks that have built up a clientele of conservative investors. Some of these houses have as many as 25,000 customers, who purchase in the aggregate over a hundred million dollars' worth of bonds

each year. Some houses are able to boast that no customer has ever lost a cent in principal or interest thru the default upon any bond which they have sold to him.

They carefully investigate the issue before purchasing and watch it very closely afterwards in the interests of customers. The business of such bond houses is founded upon their reputation for sound judgment and integrity. The individual buyer relies upon his bond house to inform him correctly, and it is only by so doing that the bond house is able to thrive. Hence such houses frequently retain an active interest in the management of the corporations whose securities they have underwritten, and even purchase back at a loss bonds which have not turned out as well as expected.

Weekly or monthly letters, and special announcements of new issues are mailed by each house to its list of customers. Bond salesmen are employed who travel over the country calling on customers, advising them on market conditions and selling bonds. Altho there are not many bond houses, it is said that some four hundred such salesmen, mostly university graduates, are employed by them in the United States.

Bond houses will handle none but the very best bonds, taken on after the fullest investigation, which seem to bear no possibility of default in principal or interest. This practically confines them to the best railway, municipal and public utility issues.

Some houses specialize in certain types of bonds, but nevertheless sell a general line in order to meet the requirements of customers. Altho many of them do business thruout the United States and Canada, each house is strongest in some particular territory, where the bulk of its sales are made. Bonds purchased from such houses carry very little risk to the investor, whose individual judgment is rarely as sound as that of the investment banker.

9. *Sale of speculative securities.*—Altho many railway and industrial stocks of a speculative nature are underwritten in the manner previously described and sold upon the stock exchange, there are many issues of corporate securities which are either too small or too speculative to be sold in this way. Mining stocks and small industrials, for instance, must usually be sold direct to the speculative public, because no special machinery exists for marketing them.

There is a certain class of brokerage house, it is true, which purports to market such securities upon a commission basis, but they are usually frauds. Their game is to obtain from the corporation a cash advance to cover the expense of imaginary salesmen and advertising. When the corporation refuses to advance further funds, the broker accuses it of quitting just at the critical time, when the efforts of his salesmen are about to be successful. The blame for failure is thrown back upon the corporation, and two entries are made to profit-and-loss accounts, one by the

corporation on the loss side, and one by the broker on the profit side.

The reason why no marketing machinery exists for this class of security is that the losses are so great that no clientele can be obtained and held by any firm in this business. Plenty of enemies can be made, but few friends.

Speculative securities of this type are sold by newspaper advertisement, mailed circulars and direct personal solicitation. The appeal is usually to the cupidity and imagination of the prospective buyer, and the prospectus is a work of art. The test of such a prospectus is to endeavor to select from it the absolute statements of fact which pertain directly to the business of the company whose stock is being offered. Often dozens of pages may be read without finding one such fact. All representations are prefaced by some such phrase as "Competent witnesses declare," "No one can see this beautiful country without believing," "Leading engineers who have investigated the proposition report that in their opinion." Dividends of 100% or even 1,000% are freely predicted. Much space is devoted to pointing out the tremendous profits which other similar companies have made, with the inference that the present opportunity is equal to any of these others. Unfavorable facts are omitted, or given only superficial consideration.

"And opportunity knocks but once," we are told. If they get all your spare cash the first time, there is no need of knocking again. Some of our readers

have probably already learned from experience or observation how anxious the "fakers" are to take their money from them. Those who are uneducated in business or finance, and some who are, appear to be unable to distinguish between facts and plain "optimism."

10. *Alluring announcements.*—It is not intended to infer here that all speculative stocks are fraudulent, or necessarily worthless. But a large majority of them are absolute losses and many are fraudulent. Notice the difference between the term "fraudulent" and the term "illegal." By carefully avoiding any incorrect statement of fact, a swindling prospectus becomes legal, and yet may openly perpetrate upon ignorant persons the worst kind of fraud.

At the time this is written, the newspapers and mails are full of advertisements of this class. The writer has before him a newspaper containing the advertisements of six companies, all of which are paying illegal dividends out of capital and then advertising the stock on the strength of dividends. The sole assets of each of these companies consist of one hole in the ground, one wagon load of pretty stock certificates, and one wise old owl for a promoter, in whose pocket is safely tucked away all the cash paid in by subscribers, which has not been paid out in unearned dividends or advertising. The two actual advertisements which follow illustrate better the nature of such announcements. Of course the names have been changed to prevent hard feeling.

EASY PAY CLIMBING

OH YES! We told you, OH YES! We went further than that—We WARNED you that EASY PAY Copper would climb by Wednesday—and this is WEDNESDAY and EASY PAY Copper is 24c a share today—But it won't be 24c long. That's final.

It is no more than fair to you, as well as ourselves, that we again warn you that EASY PAY will be higher Friday and Saturday—Still higher Monday—we mean it.

The first DIVIDEND is in sight, for the "road" to DIVIDENDS should be assured very shortly, when the last spike is driven into the last railroad tie—then the railroad to our camp will be completed. This means that the heaps of ore already mined will be on the way to the smelter. Shipments mean earnings—Earnings mean profits—Profits mean Dividends.

Just a bit of parting advice—You have had fair warning—Tomorrow positively and unconditionally concludes the sale of this stock at 24c a share. We predict 50c a share within a few weeks—and $1 a share within a few months.

Call or write for information. Wire or phone in your order at our expense. Open every evening this week until 10 *o'clock.*

JUST 4 DAYS MORE

And then up goes the price. This is merely a warning to those who are inclined to delay, put off or otherwise delay doing the thing they really want to do.

If you have read our past advertising, literature, etc., you must have been impressed by our fair and square statements—the right from the shoulder way we presented our proposition, basing our arguments on the cold facts as we saw them.

We have never tried to influence anyone against their judgment, nor to take money from anyone who could not afford to invest in a proposition like ours knowingly.

We believe, firmly, that we have one of the best oil stock

investments being offered and we are proud to explain all the facts to any one interested.

AT 75c PER SHARE

You can become a stockholder in our Company if you act quickly, but as the time is short, we advise you to get busy.

REMEMBER, unless your subscription is delivered at our office or is in the mails not later than midnight, Jan. 13, 1917, you will have to pay a higher price, if you can get it at all.

If you want advice regarding the value of our leases, just ask any real oil man or take a trip out and look our fields over and judge for yourself.

Do any and everything you choose to satisfy yourself regarding the **great profit possibilities** of our stock—only do it right away and then buy, buy and buy every share you can afford to pay for.

THE EMPTY HOLE OIL COMPANY.

REVIEW

State four methods of selling corporate securities.

Name the principal elements in the marketing machinery and describe the functions of each.

What should an investment prospectus contain? How does a speculative prospectus differ from one for a well-established concern?

What is underwriting and what are its advantages?

Describe the different forms of underwriting arrangements.

What operations does an underwriting syndicate usually perform?

When are securities sold directly to the public? What are frequent characteristics of such securities and the methods of marketing them?

CHAPTER XVIII

FINANCING THE SMALL COMPANY

1. *Special methods for small companies.*—Small companies, with a capital from $10,000 to $200,000, are usually locally owned. Their securities are not listed on the exchanges, nor are they underwritten or sold by investment bankers or large brokers.

While many are directly concerned with financing or managing small or moderate sized corporations, few are fortunate enough to control the destinies of larger companies. And yet, in our financial literature, little or nothing has heretofore been written, about small companies. The reader who wants to finance a $100,000 corporation, and who most needs instruction, finds little assistance in existing texts, and while the large company can afford to employ expert financial counsel, the small incorporator is usually unable to do so.

Underwriters and brokers will not take the trouble to investigate, underwrite or sell vigorously the securities of a small concern, as the income from so doing does not justify the risk and expense involved. Theoretically, the small company may obtain trade credit and bank loans in the same manner as the larger ones, but in practice it finds itself at a disad-

vantage. The average investor favors the large company because it appears more substantial, mere size lending an aspect of competence and reliability.

For all these reasons, small corporations are financed mainly upon the personal basis. Acquaintanceship, personal influence, friendly interest, local pride, and other similar factors enter largely into the financing. The purpose of this chapter is to outline the usual methods by which such small companies obtain their capital and finance themselves thru the early stages of their exsitence.

2. *When a going concern is incorporated.*—There is little difficulty in incorporating and financing an established small business which has existed successfully under the sole proprietorship or partnership form. Any well informed accountant or attorney can devise a financial plan for this purpose.

It involves taking out a charter with sufficient authorized stock to purchase the assets of the business which is being incorporated, and enough additional stock or bonds to provide the enlarged capacity and the new working capital required. The owners of the previous business usually take the controlling interest and sell the other securities. Local investors or bankers, familiar with the past success of the business, require but little inducement to purchase the remaining stocks and bonds, especially when the money is to be used in expanding the business.

When the corporation has been fully organized, it purchases the assets of the old concern, issuing securi-

ties to the former owners in part or full payment, and obtaining new capital by the sale of the securities remaining. Provision must be made in the plan for adequate additional working capital, since the incorporation of a business does not usually involve the purchase of the cash on hand, and frequently does not include the purchase of the accounts receivable, unless these are guaranteed by the previous owners. Furthermore, it is customary to expand the business at the time it is incorporated, and neither trade credit nor current loans can safely be relied on for such a purpose.

3. *When a new business is to be established.*—The financing of a new company is ordinarily very different and more difficult. In nearly every case, a small new company, not based upon an already established business, is founded upon one or more of the following elements:

1. A new patent right or process
2. A new local trade opportunity
3. The special ability or good-will of one or more experienced and previously successful men, whose connection with the concern inspires confidence in its success
4. Some prominent business or financial connection of the principal parties.

Few small concerns are successfully promoted unless one or more of these elements is present. A few instances of actual companies located in a small city in Pennsylvania, will make these points clearer.

A $200,000 tool company was formed and its stock sold locally on the strength of new inventions and the skill of two experienced tool makers.

A real estate company was formed to sell lots and construct houses in a new subdivision opened to provide homes for employes of the new shops of the Pennsylvania General Electric Company. This capitalized a local opportunity.

A new $100,000 lithograph company was financed by local capital, largely by former employees of a man who had previously built up in the same city a lithograph business which had sold for nearly three-quarters of a million dollars. Having lost his money in another venture, this man's experience and high standing in the business were successfully utilized to build up this new company.

A small manufacturing company was successfully financed by the son of a prominent local citizen. Father's influence having sold the stock and secured outrageously ample bank accommodations, the son, who did not believe in work, proceeded to run the business into the ground. What father did next is another lesson in finance, recounted later.

4. *Sources of funds; bank loans.*—Funds for small incorporated enterprises may be drawn from any one or more of seven principal sources:

Bank loans
Trade credit
Loans on collateral

Sale of stock to local capitalists
Sale of stock to small local investors
Sale of stock to employes
Sale of stock to customers.

Some of these sources are not very frequently employed. The backbone of the financial plan, as in the case of larger companies, is the sale of capital stock, since trade credit or other forms of borrowing cannot usually be utilized without first having some paid-in capital.

Unless the new business is founded upon some prominent financial connection or is backed by the indorsement of local capitalists, the banks cannot usually be depended upon for much working capital. Knowing how hazardous the small new enterprise is, financial institutions hesitate to loan to it until a sound basis of earning power has been established. In its relation to the banks, the new corporation is at a greater disadvantage than either the sole proprietor or the partnership. The delegated and changing management of the corporation, and the limited liability of stockholders, weaken the credit risk. A dozen small home owners, associated in a small enterprise as partners, might have no difficulty in borrowing on their joint note whereas, the same individuals, composing a small corporation, would receive but scanty recognition.

Furthermore, banks are always fearful lest funds which they loan to new enterprises, be used for per-

manent investment and not in self-liquidating transactions. The capital requirements are usually underestimated in the financial plan, in fact are rarely fully known before the second year. Meanwhile, the treasurer is under the painful necessity of endeavoring to "explain" delays to suspicious trade creditors and to convince the banks that they should advance funds to finance "the rush of new business" and meet "purely temporary" requirements. If the banker succumbs to this frantic appeal, often honestly but mistakenly made, he will probably find later that his funds have been merged inseparably with the permanent capital of the business and cannot be repaid conveniently. New companies are chronically short of capital. Hence the reluctance of bankers to loan to them.

5. *Sources of funds; trade credit.*—Trade creditors, altho cautious with new concerns, may usually be counted upon to extend assistance. Occasionally, when a connection appears to be a promising one, trade creditors will even take a small amount of stock or a few bonds in part payment for the first invoices. More often, they are found willing to extend additional time upon the first invoices until the new concern can get into operation. Frequently notes are taken, due serially in small amounts and extending settlement over many months. The writer remembers one instance in which a small lithograph company purchased its first large press by signing an entire book of promissory notes, due at the rate of $25 a week and extending over several years. The earn-

ings of this press more than paid the notes and, within twelve years, the concern was one of the largest and most successful lithograph houses in the United States.

Everyone is familiar with the way in which wholesale houses finance new retail concerns by granting large credit, extending often over a period of six months or a year. In such cases, complete financial statements are usually required, and the retailer's purchases are confined to one or two large jobbers, who watch his progress very carefully.

A brokerage company in Toronto, Canada, with a paid in capital of $50,000, has been able to accumulate assets exceeding $150,000 by purchasing on long term trade acceptances, and selling on the thirty and sixty-days' open account and acceptance basis.

Construction companies, machinery supply houses, equipment concerns, and others of similar nature, frequently assist the financing of small companies by granting liberal time on notes and trade acceptances. Long term notes are frequent in the purchase of printer's machinery and plumbing supplies, and many successful concerns could not have begun business without this assistance. It is a legitimate source of funds for the small new corporation, but a very risky one. It is much better financing, when possible, to sell enough stock and bonds in the beginning to provide the full equipment and permanent working capital, without depending on banks or trade creditors.

As the business grows, it will develop trade credit and use it to meet growing capital requirements.

6. *Selling stock to customers.*—Customers may contribute in two ways to the financing of a new small company. One is by the purchase of stock, which is rare and not at all to be counted upon. The other is by placing orders for future delivery, which may be used in turn as a basis for obtaining bank or trade credit. This latter method is frequent. An unusual case will illustrate the first.

Two men in New York City, possessing an extensive knowledge of selling and a new process for producing after-dinner confections, determined to finance a new $50,000 company on their customers' capital. Very little equipment was needed, as the product consisted of an assortment of attractive five cent packages, made in one shape and from one substance, but possessing different flavors and labels. The selling expense, however, would normally be very high, and particularly the cost of introducing the brand.

With a few hundred dollars, these men first contracted for a small quantity of their product from a reputable manufacturer, who supplied the product, labels, cartons and all, at a stated contract price. Then a small, but attractive, prospectus was issued in pamphlet form, describing in glowing terms the advantages of the product and the splendid business which the new company would doubtless develop. The authorized capitalization was $500,000, altho the

promoters only expected to raise $50,000 in cash.

With the samples and prospectus in hand, the two men individually canvassed a portion of the retail trade in New York City. Their proposition to the retailer was that he should place with them a contract for the confection equal to his full annual requirements, at the usual prices prevailing for similar confections, which were clearly no better than the new product. As a consideration for doing so and for ordering by mail as required, thus avoiding the expense to the seller of frequent sales calls, the retailer was to get a full-paid certificate of eight per cent preferred stock, to the par value of one dollar, with each ten-dollar carton of goods ordered, in addition to the usual quantity discount on larger orders. The preferred stock was to be delivered on payment of the invoice. All orders were taken for future delivery, with the exception of the first ten-dollar carton, which was delivered then and there upon an order calling for payment within ten days.

It will be noted that under this plan the retailer was paying no more than usual for his goods, but was receiving in addition a ten per cent bonus in preferred stock. This made him a stockholder in the new company and presumably a regular customer. On the other hand, the new company was giving away nothing, since the preferred stock delivered to retailers represented merely the amount which would otherwise have been paid to retail salesmen, or advertisers, to market the product. The usual profit would ac-

crue to the company from the manufacture and sale of the goods. The plan was based upon a clever device to reduce the expense of selling repeat orders, the saving being refunded to the purchaser in capital stock to insure his continued support. The issue of stock under these circumstances was equivalent to selling it for cash and then using the capital to advertise and sell the product of the company.

All the stock was originally issued to the two promoters in exchange for the full right to the process, names, designs, etc., under which the product would be produced. The $300,000 preferred stock would finance sales up to $1,500,000, on which the normal gross profits to the company were expected to be $300,000. Out of this profit were to be paid dividends on the preferred, the cost of selling introductory orders, and administration expenses. It was calculated that $100,000 would remain, half for dividends on common, and half as cash capital donated by the common stockholders to finance the business. By the time the preferred stock would become exhausted, the business would be established on a profitable basis, they calculated, leaving the company free to increase the capitalization or change the form of their selling contracts, which expired annually. This idea was drawn from the somewhat similar scheme of financing cooperative drug houses, and at last reports was operating successfully.

Customers can seldom be relied upon, however, to finance a business unless it begins operation as a

purely cooperative company, as in the case of cooperative jobbing houses owned by retail associations, such as are found thruout the United States.

7. *When employes own the stock.*—There are a number of small cooperative companies which are financed largely thru the sale of stock to prospective employees, who cooperate in the establishment of a local business in which they will be workers and also desire a proprietary interest. Few people realize how many small companies are partially or wholly financed in this way. A skilled artisan who owns his home and has a small bank account is interested in securing permanent employment near his residence and in sharing the profit and prestige which his former employers in the same community have reaped. He feels that his knowledge of the business enables him to invest in it intelligently and that his employment will be more interesting and secure when he is associated with the enterprise as part owner. He may become a foreman, or even a director. Pride plays no little part in the transaction.

Great care is required in organizing new concerns under such conditions, to prevent their foundering upon the rock of mutual jealousy and distrust. Ordinarily, there must be some one man at the head of the undertaking who has the confidence of all concerned and whose past experience and ability will insure a continuous and successful management. The reputation of this man is often the greatest single factor

in the success of the company, especially in obtaining trade credit and the confidence of customers. One man can usually manage a company better than a dozen men can. Too many fingers spoil the pie. An actual instance will serve to illustrate the organizing of such a company and the dangers of decentralized authority which beset it.

8. *Dangers of large stock ownership among employes.*—Beginning with $500 borrowed capital, a successful lithographer had built his business up unaided in a few years, and enjoyed the highest reputation in the trade. He then sold his business to a combination in New York for nearly three-quarters of a million dollars in stocks, bonds and cash.

The new managers ran the business into the ground in a very few years. Meanwhile its founder, in other ventures, succeeded in losing the fortune derived from the sale of the enterprise. Former employes now suggested a new company in the same city, where most of them owned homes which they did not care to leave. In this way, they sought to profit from the experience and ability of their former employer. It was understood that they would take stock on the same basis as himself and that as much stock as necessary should be sold to outsiders to complete a capitalization of $100,000.

The new company began operations with its capital partly paid and with great enthusiasm pervading the working force. Credit was generously extended

to it on the reputation of the manager, and the first year's operations showed a small profit. Meanwhile, discontent had arisen when many of the new stockholders found that they had no more direct authority in the business than employees who did not own stock. Apparently each of them had expected to share directly in framing the policy of the company, not realizing his limited authority as stockholder. The manager, who did not control the stock, and who was devoting his time to the business instead of to corporate politics, was suddenly voted out of office by an organized opposition.

The men who had sought and obtained control now quickly discovered that they did not know how to exercise it. Within three weeks the credit of the concern had been vitally injured with the trade, discipline had deteriorated in the plant, and almost everything went wrong in the new company that possibly could. In self-defense, some of the larger stockholders then banded themselves together and reinstated the old manager with full powers. At the present writing, this little company is still suffering from a certain degree of divided authority, altho enjoying a labored success. Had the manager owned control, it would, without question, have reached twice its present size and earnings by this time.

9. *Subscription and sale of stock.*—Small companies should, if possible, sell enough capital stock in the beginning to provide their entire capital, including working capital. Control can be retained by the

promoters, if minority stockholders, by dividing the stock into two classes, the preferred voting only when dividends are passed. For instance, a company requiring $200,000 capital may incorporate for that amount, half common and half cumulative preferred stock at seven or eight per cent. The promoters, by reserving the voting power to common, and taking $51,000 of it, may retain control of the company.

If this plan is not sufficiently attractive to the preferred, the same amount of capital may be secured in another way, by a process of inflation or over-capitalization. In this case, the capitalization would be raised to $300,000, half common and half preferred. The promoters, for some patents, copyrights, etc., and $50,000 cash, would issue the entire common stock to themselves. The preferred would then be sold at par, accompanied by a bonus of one share of common for each two of preferred, and the cumulative dividend rate on the preferred would be reduced to six or seven per cent, instead of seven or eight per cent. The motive behind this is to add the speculative element to the preferred, so that it may be more readily sold.

This amounts to the same thing, as far as the corporation and the common stockholders are concerned, as selling the common stock at one-third and the preferred at five-sixths of its par value; and that is why the interest rate on the preferred is reduced one per cent. Each preferred stockholder, for $100 invested, receives:

$50 par value common at ⅓	$16.66
$100 par value preferred at ⅚	83.34
$150 par value, all told, for	$100.00

As we have seen in the chapter on Capitalization, the number of shares of common issued and the price at which it is sold make no difference, but any reduction in the price received for preferred stock or bonds cuts into the equity of the common stockholders. For this reason, in the second plan, the preferred dividend is cut one per cent per annum as an offset to the reduced rate at which preferred, in effect, is sold. In either event, the promoters control the company, because they own a majority of the outstanding common stock.

10. *Promoter's share in the enterprise.*—Stock may be sold to large investors, small investors, promoters and employes. As a general rule, it is wise for the promoters, who are usually interested parties in the small corporation, to invest liberally in the enterprise themselves, and to control its operations for the first few years. This lends strength to their appeal for funds. It shows their own confidence in the business, lessens the amount which will have to be secured from outsiders, and injects the necessary personal element into the solicitation for subscriptions.

11. *Selling stock locally.*—If large local investors are to be interested, they should be approached first. Sometimes, capitalists will take a few shares merely

to lend their names and good-will to the enterprise. Usually, however, such men are not interested unless they can control the enterprise. Whether the promoters, owning a minority interest, are safer in the hands of a few large investors than in the hands of numerous smaller ones is doubtful. It depends upon the circumstances in each case. As a rule, the company will be much stronger with a few large stockholders, than with many small ones. If, however, it is strictly a local venture depending upon the good-will of the public, the small stockholders may be preferable or even necessary.

We have already seen the dangers of the small company with many stockholders among employes. On the other hand, large controlling stockholders are likely to freeze out, in time, the practical minority who organized the company.

12. *Circulating the subscription lists.*—If a large number of small stockholders is desired, it is advisable to have several subscription lists, each beginning with a few well-known signatures. Some of the lists will be for large subscriptions, others for smaller ones. The organizers may have several lists circulating at the same time. Subscriptions may be payable in easy amounts, as ten per cent down and ten per cent each month. Certificates may be delivered for each payment when made, or may be withheld until the full payment of the subscription has been completed. In either case, the terms of payment should be clearly stated on the subscription list, and

receipts should be issued for payments not evidenced by certificate. The easy payment plan has the merit of interesting many who could not otherwise subscribe. The practice of withholding the certificates until the full subscription has been paid has, at least, the merit of forcing subscribers to a more careful observation of the terms of subscription.

13. *Importance of the prospectus.*—Whether the stock is sold to large investors or to small ones, to outsiders or to employees, a prospectus will be needed in any event. The prospectus may be an informal document, printed or typewritten, but whatever the form, it should be neat, clear, concise and well arranged. A well-worded typewritten letter is often as good a prospectus as may be had. The lack of a good prospectus is a frequent cause of failure in the promotion of small companies. As a rule, no one but an experienced financier can properly draw such a prospectus. Practical psychology plays a large part in it. It is a matter of salesmanship of a special kind which knows the mind of the investor and the practices of finance.

One instance is recalled in which two entire days were spent writing and rewriting one three-page letter. But the time was well spent, for this letter sold $140,000 worth of seven per cent preferred stock to one who had no personal knowledge whatever of the business or of the circumstances surrounding its promotion.

14. *Sale of bonds and mortgages.*—Bonds and

mortgages are not commonly issued by small companies unless the assets consist largely of real estate. Established earning power is the usual basis of such loans. These the new company cannot show until it has operated for several years. Consequently, it can sell bonds or mortgages only to a very conservative percentage value of its real estate. The market for such bonds is limited, since large bond houses will not bother with these small issues and they are not ordinarily considered first class investments.

Often, it is possible to induce the owner of a factory site or vacant plant producing little or no revenue, to exchange it for bonds or stock of the new company, or part bonds and part stock. In this case, the bonds are secured by a first mortgage on the property, and improvements tend to increase the security constantly. The inducement held out to the owner is the regular return upon the securities, which he did not receive before from the idle plant. If the business fails, the worst that can happen to him is to get the property back again with improvements.

It is frequently necessary for wealthy directors or stockholders to guarantee the bonds, or at least to guarantee the interest for a period of years, if they are to be sold locally. Stocks will frequently sell where bonds will not, because of the opportunity for large profits attached to stock.

15. *Capital investment.*—One of the most frequent causes of disaster to small new companies is the in-

vestment of a large part of their capital in plant and other permanent equipment. Frequently, the small enterprise can be initiated with half the capital, and less than half the risk, by renting small quarters the first few years, during the experimental stage, instead of jumping right into a large plant investment. This leaves the capital free for current operation, and any loss occasioned by the high rent paid is usually more than recouped by the experience gained, by the mistakes prevented, and by the better basis upon which the plant may be financed when it is finally acquired. The original plant may prove inadequate, incapable of expansion to meet the growing needs of the business, may be in the wrong location, may depreciate in value or in other ways become unsatisfactory and entail loss upon the new concern.

The great reason, however, for withholding capital investment in the beginning, is to preserve the assets in liquid form and insure adequate working capital. The shortage of working capital is a cause of chronic complaint of small new companies, and should be carefully guarded against. The use of a big plant and a fine office should be foregone until the business has been thoroly established.

16. *Advances by stockholders and directors.*— When a shortage of capital becomes evident, and credit at the bank and with the trade is weakened, it frequently becomes necessary for prominent directors, stockholders, or others to indorse the company's obligations. This is always a danger signal, for it means

that those who indorse will demand concessions in return, such as control of the business, high salaries or bonuses that will seriously cripple the finances of the company.

From the standpoint of the indorser, these special concessions seem justified, for he is assuming a risk beyond his mere liability as a stockholder, for which compensation may reasonably be expected. Very few men familiar with finance are willing to indorse the notes of a company or of a friend. They realize the hazard involved. Such indorsements at best should be only temporary, and not renewed by paying one obligation and indorsing another in its place. Continuance of such practice is usually a death blow to common or minority stockholders, as the bonuses demanded eat up the profits at the expense of dividends. The indorser, to protect himself, sometimes finds drastic measures necessary. Very often these include squeezing out his associates by foreclosing and buying in the business.

We shall illustrate by referring again to the small tool company which the rich man's son had financed upon the reputation of his father, and then mismanaged. The company had accepted much aid, including generous loans from the bank of which the manager's father was director. Observing the impending failure, the father now advanced his son's company a few thousand dollars more, taking first mortgage bonds as security. The new funds sufficed to carry the company over the four months' period, so that the

preference created by the bonds could not be set aside under the Bankruptcy Act.

As soon as these four months had passed, the company was thrown into bankruptcy and bought in at 25 per cent of its original cost to satisfy these bonds. Practically nothing was paid to the other creditors, not even to the bank of which the father was a director. Of course, the business was reorganized and became successful on the assets which creditors had donated. The capitalist remained until his death a director of the bank which he and his son had virtually defrauded.

REVIEW

What elements should be present before a new business is established?

From what various sources are funds for small enterprises drawn? Why are banks usually opposed to investing in such enterprises?

What assistance may trade creditors render to a new company? How may customers aid it?

If you were establishing a new company how would you provide for the sale of stock, and what provision would you make for the control of the company? How would you arrange the subscription lists to get the best results?

Why does the investment of a large part of capital in plant and equipment often bring disaster to new companies?

What is the position of a company whose obligations are being indorsed by directors or stockholders?

CHAPTER XIX

FINANCING REORGANIZATIONS

1. *Readjustment of capital account.*—Any change in the plan of capitalization of an operating company is entitled a "readjustment of capital account." Successful companies make such changes to remedy existing defects in the financial structure or to meet some new or unforeseen requirement of the business. This may be termed a recapitalization. Usually, however, such readjustments of the control, risk and income of the various stockholders and creditors follow a default or general insolvency, and constitute a reorganization of the company for the purpose of placing it upon a profitable basis.

Reorganization may be said to consist of the rehabilitation of an insolvent business thru the adoption of a new financial plan. Insolvency consists of inability to pay maturing obligations in cash. The business may have a great excess of assets over liabilities, but if it cannot meet its obligations in cash, it is nevertheless insolvent.

2. *Bankruptcy versus receivership.*—Bankruptcy is the judicial settlement of debt, and involves winding up immediately the business of the debtor for the benefit of creditors. Receivership, on the other hand, is the judicial conservation and operation of property

for the protection of creditors. It recognizes a state of temporary insolvency, but looks forward to a reorganization which shall readjust or settle the claims of the various parties at interest without terminating the business. Receivership is a practical necessity where the business is insolvent and the value of assets depends primarily upon a continuance of operation, as in the case of railroads.

If the properties affected, or the parties at interest, reside in different states, the receiver is usually appointed by a Federal court in order to prevent conflicts of authority between state courts and inequalities in the settlement of claims. A receiver is an agent or officer of the court, and he takes absolute possession of the property and management of the business subject to the policy and direction of the court. A receiver will not be appointed unless the court can be shown that there is an actual default and that a receivership is necessary to prevent loss or injury to creditors.

Under the receivership, the legal remedies of the individual creditors are set aside in order that equal justice may be extended to all. The receiver may affirm or disaffirm existing leases and may operate all of the properties or only part of them. Since the property usually comes into his hands badly run-down, and the business short of working capital, he has the power, under orders of the court, to borrow upon receiver's certificates for the purpose of making needed repairs and financing efficient operation.

These certificates may take such priority over existing company debts, secured or unsecured, as the court may assign to them. In fact they may supersede all claims except taxes. Before the issue of such certificates is authorized, bondholders and other creditors are given an opportunity to appear and plead for or against them. Then the court, being in possession of full information, determines the size, tenor, priority, rate of interest and the selling price of the issue. They usually bear six per cent interest, mature in from two to five years, with right of redemption, and sell readily around par.

3. *Receivership of industrial companies.*—Great caution should be exercised by directors and owners in consenting to the appointment of receivers for industrial companies. Stockholders usually have a better chance of reorganization under bankruptcy proceedings, where they may bring the properties to immediate sale and purchase them at a fraction of their operating values and free from debt. Usually a large part of the equity of the stockholders may be preserved in this way, as others are not likely to bid as much as the properties are worth to the stockholders. Of course, the stockholders must be able to raise the money to buy the plant in, and often they are able to do so when they could not secure outside support with which to rehabilitate the old company with all its debts.

For instance, a concern with liabilities amounting to $100,000 and assets of $175,000, would sell under

foreclosure for perhaps $50,000, since the plant, machinery and stock are designed especially for that business and are not of much value to others. By purchasing at bankruptcy sale the stockholders can get a property, free of debt, worth to them over twice its sale price. Against it they may readily borrow at once most of the cash paid for it. But probably no one could be found who would advance these funds to reorganize the old company with its large debt.

Only when industrial receivership is friendly to, and dominated by, experienced management in the interests of stockholders, does it hold out much hope of a fair reorganization. As a rule, creditors are neither technically informed in the business nor interested in saving anything for stockholders. If preferred creditors dominate the receivership, they are likely to ride rough-shod over general creditors and stockholders alike. All they are interested in is the payment of their claims. The interests of others receive but scant recognition. The court will usually follow the recommendations of the receiver, even tho junior creditors and stockholders may oppose. Reorganizations which give any chance to stockholders or unsecured creditors are scarce where the receiver is the nominee of preferred creditors.

One illustration of this will suffice. The names are omitted for obvious reasons. A company with a splendid business, assets twice its liabilities, and with no preferred creditors got into difficulties for lack

of working capital. Certain bankers, being large creditors, suggested a friendly receivership pending reorganization. One of those suggested by the bankers for receiver approached the principal stockholder, who was also manager, and promised that if appointed, he would retain the practical management in office and represent the stockholders' interests in securing a satisfactory reorganization.

Upon these assurances, he and one other were appointed receivers, with the consent of the stockholders and upon the advice of an attorney who had represented the principal stockholder for fifteen years and who was also attorney for the bankers. To make a long story short, this business was wound up in a short time, with the bankers as preferred creditors. Others received practically nothing, except the receivers and the attorney, who fared richly at the expense of the stockholders and the unsecured creditors. Needless to say, the former managers were not consulted under the receivership, nor would such consequences have been possible under their advice. No opportunity was given them to reorganize or to pull their company out of difficulties. This "coup" was accomplished by the postponement of action of the other creditors and stockholders past the four-months period required for the bankers to get preferred security, thus avoiding bankruptcy proceedings under the National Bankruptcy Act.

Immediate proceedings in bankruptcy would have been the proper course and would have been ad-

vised by any independent and experienced attorney, had the stockholders engaged one. This is a typical case of misplaced confidence and poor financial policy. Many unsophisticated business men have been misled in this manner trying to reorganize their companies under secretly hostile or unprincipled control.

4. *Elements of reorganization.*—The reorganization of a large company is a complicated matter, especially where there are many widely scattered interests, with various grades of claims against the company. In the railway field, frequent reorganizations have led to the adoption of a fairly uniform procedure involving the following elements:

1. Company placed under receivership
2. Voluntary protective committees formed to represent each class of creditors and stockholders in the company
3. Deposit of securities and claims with trustees, under trust agreements drawn up by each of the various protective committees, giving the latter certain powers to act in the interests of the claimants whom they represent
4. The selection, by joint action of the various protective committees, of a reorganization committee to formulate and submit a plan of reorganization
5. A thoro examination and appraisal of the property as a basis for the court to fix an upset price, and the reorganization managers to carry thru an equitable plan of reorganization
6. Reorganization plan drawn up and submitted

for the approval of the bankers and protective committees, naming therein certain reorganization managers to carry out the plan

7. If the plan is found satisfactory, an underwriting agreement is made between the reorganization managers and interested bankers to insure adequate new capital for the reorganized undertaking

8. A reorganization agreement, embodying the details of the plan, is drawn up and submitted to the various security-holders, who are asked to deposit their securities with trustees for the purposes of consummating the reorganization

9. Campaign to get the assent of security-holders to the new plan and to eliminate dissenting minorities

10. New company incorporated to purchase the business and property

11. Foreclosure under the defaulted security, and cash settlement with security-holders who are not participating in the reorganization

12. The issue of new securities and the collection of assessments for the purpose of converting into securities of the new company the claims of those participating in the reorganization

13. The pooling of the new stock under voting trustees for the purpose of securing a continuous and uninterrupted management during the early and critical period of the new company.

It will be noted that the reorganization managers have been compelled to organize a new corporation and to receive the cooperation of the receiver, the

court, the bankers, and a large majority of the old security-holders and creditors in order to effect a successful reorganization. The details and steps may vary, but the foregoing outline is typical.

5. *Security-holders' protective committees.*—In case of receivership, protective committees usually spring up immediately for each class of security and for unsecured creditors, the importance of each committee depending upon the value and class of the claims deposited with it. The most important committee is that representing the principal issue in default. In order to forestall opposition committees, the management of the company, anticipating default, usually arranges in advance with well-known claimants of each class to announce themselves as a self-appointed protective committee immediately upon the appointment of the receiver.

Each committee invites all its fellows in misery to deposit their securities and claims with a certain stated trustee for mutual protection. The trustee is usually a trust company, and it acts under the terms of a deposit trust agreement, which outlines the duties of the trustee, the rights of the parties who deposit and the powers of the protective committee. The agreement, of course, binds only those who deposit, and is for the purpose of enabling the protective committee to exercise a powerful voting control in the reorganization proceedings; each committee fights for the better recognition of the class of security which it represents.

Holders of securities not in default, including even

the common stockholders, may have protective committees. Trade creditors have a committee to represent the amounts due them on open accounts. The power of each committee depends largely upon the extent to which it is successful in inducing the owners to deposit their securities or claims under the trust agreement. Owners are often slow to come forward, and there are usually some who refuse to deposit. Sometimes opposition committees spring up, and these are always a great nuisance to the reorganization managers. Sometimes a committee, as an inducement to security-holders, will itself underwrite or advance the interest upon the defaulted security, pending the reorganization. It is essential that the various protective committees, which control a large part of the outstanding securities, act in harmony if a reorganization is to be effected.

No security-holder is under any obligation to deposit his bonds or stocks with a protective committee, or to participate in the plan of reorganization. Those who deposit their securities, however, receive from the trustee transferable and negotiable certificates in lieu of the stocks or bonds or other claims deposited. Altho the protective committee represents the depositors, it cannot bind them to any actual plan of reorganization without first submitting it and receiving their assent.

6. *Deposit agreement.*—The deposit agreement gives broad powers to the protective committee. Anticipating a reorganization, it provides that the com-

mittee may negotiate with other committees, companies or bankers; plan a reorganization which involves forming a new company or a recapitalization, or provides for disposal of any part of the property; appoint managers; pay their committee expenses; and do such other things as it may find proper and expedient in the interests of its principals. All these powers, of course, are given merely that the committee may have broad scope in negotiating a reorganization.

The certificates issued by the trustee to the depositing security-holders state the names of the members of the protective committees, identify the securities which have been deposited, refer to the trust agreement and stipulate that certificate-holders are entitled to all the privileges and benefits conferred thereby. These certificates are usually assignable by transfer on the books of the trust company, subject to the terms of the deposit agreement. On the back they have the usual printed form of power of attorney, so that, like stock certificates, they may be sold or passed by delivery at any time. The certificates may be made to bearer, but they are usually registered, and are rendered sufficiently negotiable by the power of attorney, which, when signed in blank, makes them good in the hands of the bearer for transfer on the books of the company. The purpose of the certificates is to enable the owner to possess and negotiate evidence of his interest in the corporation and yet deposit with the committee the control necessary to effect the reorganization. These certificates may be

dealt in exactly as the securities themselves, and they are often listed upon the stock exchanges.

The creditors and stockholders are compelled of course, to pay the expenses of their protective committees. Usually the members of these committees receive some compensation for their services, as defined in the deposit agreements. The greater the amount of the claims or securities deposited, the smaller is the percentage of expense, and this accounts for the reluctance of bondholders to deposit under such committees until they see how things are going. Many inducements are held out to deposit, one of the most important being a limitation upon the expense which the committee may incur. Sometimes foreign bondholders hesitate to deposit, or they may have separate committees, or utilize a separate trustee. They usually cooperate, however, with the domestic committees in reorganization.

If a reorganization upon a fair basis is likely, it is best for the creditor to deposit. If many of them refuse, their refusal may prevent a reorganization. Of course, those who deposit late are compelled to bear the same expense as those who deposited early, and very late depositors are sometimes subjected to some slight penalty.

7. *Duties of the trustee under the defaulted bond.* —It will be remembered that when the bonds were originally issued, the security was pledged with a trustee for the benefit of all bondholders, and the trustee was given authority to act for the bondholders

in the protection of their interests, including the right, under certain limitations, to foreclose in event of a default.

It is necessary therefore for the bondholders' protective committee to secure the cooperation of this trustee. He is the one who will bring the foreclosure suit, as a rule, assisted by counsel for the bondholders' protective committee. If the committee has succeeded in obtaining a large enough percentage of the bonds to control the action of the trustee, little difficulty is likely to be encountered. The trust deed usually provides what action the trustee shall take in the event of receivership or default, his duty is to fulfill these conditions and at the same time cooperate as far as possible with the protective committee. Since the trustee is not himself an interested party, the principal work naturally falls upon the committee.

8. *Examination, appraisal and upset price.*—Since most reorganizations demand that the property be sold under foreclosure and bought in by a new company representing the reorganizers, it becomes necessary that the value and earning power of the various parts of the property shall be determined, in order that the reorganization may be properly financed and justice be done both to the security holders who participate in it and to those who do not. Those who participate in the reorganization give up their old claims or securities for new, but those who do not deposit must be paid off, out of the proceeds of the foreclosure sale. There is likely to be but one bidder at the sale, repre-

senting the reorganizing interests, since any outside bidder would have to put up the entire amount in cash, while the reorganizers may settle with their own depositing members in securities of the new company instead of cash, making it much easier for them to finance the purchase.

The reorganizers are anxious to purchase the property as cheaply as possible, while the non-participating stockholders or creditors desire it to be sold at the highest possible price. When practically all join in reorganizing, the sale price is not so important. The property is usually sold as a whole in order to preserve it as a complete operating plant, altho sometimes certain parts which are not needed by the reorganizing interests are sold separately. In order to protect non-participants, the court must fix a minimum price, known as the upset price, below which no bids will be received.

After the foreclosure suit has been instituted by the trustee under the mortgage, the protective committees immediately institute an exhaustive examination and appraisal of the property. This often requires a year or more, and is used to determine the upset price and to form the basis for a reorganization. In fixing the upset price, the court will give all parties at interest a chance to be heard, but it ordinarily adopts the price which the appraisal has determined as fair.

9. *Reorganization plan.*—The plan of reorganization is usually determined by a central committee, appointed by the various protective commit-

tees. Its duty is to formulate the plan, obtain the adherence of the various protective committees and draw up an agreement embodying it for the acceptance of the various claimants. If the plan and the agreement are acceptable to the protective committees, the agreement is deposited with a trustee and advertised so that the various parties at interest may deposit their claims or securities under it and join in the reorganization.

The agreement names the reorganization managers upon whom the committee has decided, usually including one or more large banking houses which have been instrumental in financing the company and are expecting to underwrite some of the new securities. It is the duty of these managers to obtain, if possible, the assent of all the security holders to the agreement. The greater the number who participate, the smaller will be the amount of cash required to pay off dissenters, and the greater will be the success of the reorganization.

10. *Reorganization agreement.*—The reorganization agreement now supersedes the deposit agreement under which the protective committees acted. As in the case of the protective committee agreement, the owners are now asked to deposit their rights under the reorganization agreement. The same trustees are retained to hold the securities, so that no actual transfer of their possession is required.

The advertisement of the reorganization agreement often provides that owners who have deposited under

the protective committees will be considered to have assented to the reorganization agreement unless they take up within a certain length of time, usually twenty to thirty days, the securities which they have deposited previously. If the securities are not taken up, it only becomes necessary for the owner to surrender his old certificate and take a new one showing his participation in the reorganization plan.

At this point, the managers make every possible effort to interest all the security holders. In the meanwhile, they have incorporated a new company to buy in the property and have stated, in the reorganization agreement, the extent to which financial support will be accorded to this new company by the banking interests. Others who have not deposited their rights under the protective committees are now asked to deposit under the reorganization plan. This is a critical stage of the reorganization, for if the plan is not attractive, and sufficient securities are not deposited, the entire arrangement may fail for lack of adequate support.

The reorganization agreement gives the managers broad powers in carrying out the new plan, and usually provides also that the new stock, when issued, shall be pooled under a trustee for the purpose of assuring an uninterrupted management during the early years of the reorganized company.

11. *Securing new cash.*—Under the reorganization, new cash is needed for the following purposes:

1. To pay off receiver's certificates

2. To pay off creditors who are not participating in the reorganization.

3. To provide adequate new working capital and funds for needed replacements and improvements.

The new capital is secured by assessing stockholders and junior creditors who participate in the reorganization, or by selling new prior lien securities to underwriters. The bankers, having formed a syndicate, have agreed to underwrite certain preferred securities if the committee is successful in securing the participation of at least a certain percentage of the former owners and creditors. To the exact extent that new cash is not provided by assessments, it becomes unnecessary to depend upon the underwriters for it. But since no one can tell in advance how many security holders will agree to the plan, or how much will be received from assessments, it is necessary that the underwriting agreement be elastic and for a sufficient amount. If the provision of adequate cash is not absolutely assured, it is not likely that security holders will favor the plan and participate in the reorganization, as they would not care to become interested in a new company which would begin its operations hampered for working capital.

Usually the reorganization cannot be accomplished unless at least a certain percentage of the certificates are deposited under the agreement. The fact that reliable bankers are supplying new cash is one of the greatest inducements for the security holders to join in the reorganization. That is why the underwriting

agreement is made first and announced in the reorganization plan.

The underwriting agreement is between the reorganization managers and the syndicate of bankers. It is not different from other underwriting agreements, previously discussed, except perhaps that it is contingent upon the ability of the managers to secure the cooperation of a certain percentage of the creditors and to purchase the property within a fair price at the foreclosure sale.

Those who join in the reorganization will receive securities of the new company in exchange for their old ones. Since the bankers are putting in new cash to help save an involved business, they will naturally demand for themselves prior lien security and an ample underwriting profit. The former claimants will have to be satisfied largely with junior lien bonds or capital stock, with the possible exception of those who were formerly well secured.

12. *Assessment of junior lien claimants.*—The insolvency of any company, or its reorganization under receivership, rarely leaves any equity to the common stockholders and usually very little to the preferred. The trade creditors and owners of junior lien bonds are of course in a better position, but nevertheless they stand to lose heavily if it becomes necessary to sell the property in the open market. Fixed assets rarely bring at forced sale more than a third or a half of their operating value, and often less. This shrinkage is likely to eliminate entirely or to reduce

greatly the holdings of the general creditor or junior lien bondholder. Where the outstanding securities consist largely of general mortgages or collateral trust bonds, it is even possible that the owners of these underlying liens will suffer in the event of a forced sale. This explains why all parties are usually interested in cooperating to secure a reorganization which will prevent the undue sacrifice of the property and give them an opportunity to preserve their investments.

The preferred claimants are able to dictate largely the terms of reorganization because they stand closer to the property and would not suffer so much loss as the others in a judicial distribution of assets at public sale. Frequently, the junior interests are permitted to join in the reorganization only on payment of liberal assessments. In the case of stockholders, the assessment is likely to be not far from the estimated market value of the new securities which they will receive. In such case, their participation amounts to little more than an opportunity to subscribe to the securities of the new company, on what may be a slightly preferential basis, yet most stockholders like to feel that they are participating and that in some manner the plan of reorganization preserves to them a part of the equity which they formerly held.

This equity, which stockholders and often unsecured creditors imagine is preserved to them under reorganization, is one of the great illusions of corporation finance.

13. *Foreclosure sale.*—Altho the foreclosure suit

under the defaulted bonds was filed immediately after the appointment of a receiver, the foreclosure sale is about the last stage in the procedure of reorganization. The foreclosure sale does not take place until after the self-appointed protection committees have secured the deposit of a liberal proportion of the bonds of the defaulting company, have begun an exhaustive examination and appraisal, have formulated thru their special committee a plan of reorganization and appointed reorganization managers, and after these managers, having made an underwriting agreement and filed the reorganization agreement with the trustees for the assent of security holders, have secured the participation of a liberal percentage of the creditors and the assent of the court to a satisfactory upset price.

The reorganization recounted here is typical of American railroads, and often requires several years for completion. The appraisal itself may take a year or two, and during this time the plans have been going forward. Now that all is in readiness for the foreclosure sale, the assessments of stockholders are called and receipts given to them. These receipts are later converted into the securities of the new company. If not enough cash is raised in this manner to cover all requirements, the underwriters are called upon to advance a part of their cash against the new securities. To insure against fake bids, the court always requires that a liberal deposit, to apply upon the purchase price, be made by bidders before the sale.

At the sale, which is public and thoroly advertised, the reorganization managers are usually the only bidders; and the property is sold to them, or to the new company which they have formed, at the upset price established by the court. The upset price is usually less than the debts of the company, especially where blanket mortgage or collateral trust bonds have been issued. If only a part of the property were sold, deficiency judgments remaining outstanding after the distribution of the proceeds of the sale would have some value, but ordinarily the property is sold as a whole, and the unpaid portion of creditors' claims have no further values unless they have been indorsed by some outside party.

Of the purchase price, enough must be paid in cash to pay off the outstanding receiver's certificates, the expenses of the court, and the amount required to be distributed to creditors or others who are not participating in the reorganization. The balance, representing the amount distributable to those who are participating, is payable either in securities of the new company or in securities of the old company which have been deposited under the reorganization agreement, and which will be exchanged later for the new securities under the direction of the reorganization managers.

When the sale has taken place, all the non-participating stockholders and creditors have been eliminated, and the property and business, now in the hands of the reorganization managers, or of the com-

pany which they have formed, is free from all debt, except such as the new plan of capitalization provides. Nothing remains to be done in the reorganization, except to distribute the new securities in accordance with the reorganization agreement and place the managers of the new company in charge.

14. *How the new plan reduces the fixed charges.*— The plan of reorganization must provide a reduction of the fixed charges to a point well below the estimated annual income. This is accomplished in one or more of several ways, of which the following are the principal ones:

1. Reducing the amount of the fixed interest-bearing debt by the substitution of capital stock or income bonds for a part of it

2. Reducing the interest rate upon the interest-bearing debt, sometimes substituting a stock bonus as partial compensation

3. Disposing of certain unprofitable parts of the property or business.

When possible, the scheme of capitalization is simplified under the reorganization, with fewer classes of securities and a liberal bond reserve to take care of renewals and extensions. Preferred stock is very often issued to take the place of junior lien bonds. It ordinarily bears six per cent interest and is cumulative, so that the dividend upon it, if paid, will at least equal the interest which bondholders were formerly entitled to receive.

The chief feature of the reorganization, therefore,

is a reduction all the way down the line of the lien upon earnings which the various claimants formerly had. Junior claimants frequently suffer reduction in both the amount and grade of their holdings. Certain preferred creditors, deriving no benefit from reorganization, may retain their position undisturbed. It is only by this reduction in fixed charges and the provision of adequate new working capital that the bankers and the owners of the prior lien bonds of the old company are induced to join in the reorganization, feeling that under the new plan there will be no necessity for another default. The par value of the new securities issued to the old bondholders probably will not be reduced, but may even be increased, in order to render more palatable the adulteration in their quality or lien. The investor's mind clings to par values, and the sense of loss in the matter of security is not felt so keenly if the total par value is not reduced.

The new stock has some speculative value, and this induces the old stockholders to come forward with assessments. Bondholders or other secured creditors cannot usually be subjected to assessment.

Oftentimes property, which was formerly only leased by the corporation, is now taken over outright thru some compromise with the lessor, thus increasing the value of the equities of the new corporation. For instance, leased railroad equipment may bear the name of the lessee road and be in poor repair. The lessors

therefore are willing to compromise their claims and turn the equipment over to the reorganized lessee absolutely.

15. *Reorganizations in Canada.*—The reorganization of Canadian corporations in recent years has occurred chiefly in connection with industrial amalgamations. Prior to 1912, during a very active period in Canadian development, a large number of amalgamations were executed, heavy capitalization being one of the outstanding features of this movement. Since then, the majority of these amalgamated companies have had to be reorganized, resulting in many cases in pronounced reductions in the stock and bond holding of investors. One typical example may be cited. An industrial consolidation, with heavy capitalization, broke down in 1912. Action was taken by the directors and a bondholders' committee was appointed to save the company from complete disaster. In submitting their reorganization scheme, this committee pointed out that it was evident from the operations of the company, that the original capitalization involving a fixed charge of $400,000, was excessive. The average earnings for a period of 3½ years were not less than $250,000 and under normal conditions the company should exceed this. A plan of reorganization was submitted, suggesting the formation of a new company. Under this plan, a drastic cut was made in the bonds and share capital. The holder of $1,000 par value of bonds in the old company received $250 first mortgage bonds in the new

company, $500 new 6 per cent preferred stock and $250 new common stock.

The reorganization plan is seen at a glance in the following table:

	Before Reorganization	After Reorganization
Common stock	$ 8,125,000	$ 3,000,000
Preferred stock	1,875,000	4,000,000
Bonds	8,000,000	3,000,000
	$18,000,000	$10,000,000

The stock of the old company disappeared. The bondholders of the old company received $2,000,000 in common stock, $4,000,000 in preferred stock and $2,000,000 in bonds. To secure working capital the new company issued $1,000,000 in common stock and $1,000,000 in bonds.

The new company started operations on July 1, 1912, and while early results were not remarkable, they later showed progressive improvement. Net profits for the first ten months of 1916 were $437,318, against $386,777 for the full year 1915, and $343,236 for the full year 1914, with a surplus after charges, greater than the combined surpluses of those two years. Indicated earnings in 1916 on the preferred stock were at a rate of 5 per cent.

When refinanced in 1912, the company was started with a substantial sum in cash for working capital, and the policy of the board was to maintain that position. Surplus earnings went into improvements and betterments; but expenditure of that sort was kept within the bounds of earnings so available and there was no impairment of the company's financial liquidity. Each of the successive statements issued since

reorganization has shown the company in possession of about $450,000 to $500,000 cash and no debts other than ordinary trade accounts.

The company's strength in this respect and its gradual accumulation of a surplus, which on October 31, 1916, amounted to $450,369, or equal to about 11 per cent on the stock, allowed the directors in January, 1916, to declare a modest quarterly dividend of 1 per cent on the $4,000,000 preferred stock of the company. This stock represented a 50 per cent equity in the bonds of the old company, rather than an original stock investment.

REVIEW

What is the essential difference between bankruptcy and receivership?

Who appoints a receiver and what are his duties?

If you were a stockholder of an industrial company which had failed would you consent to the appointment of receivers or would you be willing to reorganize under bankruptcy proceedings? Give reasons.

What is the usual procedure in the reorganization of a railway company?

What is the purpose of a deposit agreement? Of a reorganization agreement?

In a reorganization, what group is the most important? What is the position of the junior creditors and the stockholders?

How are fixed charges reduced in plans or reorganization?

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